

INFLATION AND GROWTH:
THE ECONOMIC POLICY DILEMMA

The Congress of the United States
Congressional Budget Office

PREFACE

Inflation and Growth: An Economic Policy Dilemma is one of a series of reports on the state of the economy issued periodically by the Congressional Budget Office. In accordance with CBO's mandate to provide objective analysis, the report contains no recommendations. It was prepared by George Iden, Cornelia Motheral, Joan Schneider, Steven Zeller, Nancy Morawetz, Nariman Behraves, Marvin Phaup, Toni Gibbons, Rebecca Summerville, John Jacobson, and other members of the Fiscal Analysis staff, under the direction of William Beeman and James Annable. Patricia H. Johnston and Marion F. Houstoun edited the manuscript. Special recognition goes to Debra Blagburn, Dorothy J. Kornegay, and Marsha L. Mottesheard for their skill and patience in typing the many drafts.

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SUMMARY

Consideration of the Second Concurrent Resolution on the Budget for Fiscal Year 1979 presents the Congress with difficult choices. Inflation is accelerating, while the economic expansion is giving indications of running out of steam. Consequently, there is a troubling policy dilemma: standard anti-inflation measures may weaken growth and, perhaps, lead to a recession, while policies designed to sustain the expansion may increase the pressures on prices.

THE CBO PROJECTION

Any forecast of economic activity depends critically on how policymakers respond to this dilemma. The CBO projection is based on the following assumptions about economic policy:

- o The fiscal policy is as given in the first concurrent resolution, including a \$15 billion tax cut for fiscal year 1979 to take effect in January;
- o With respect to monetary policy, it is assumed that short-term interest rates will not rise much further and that credit conditions will not become so restrictive as to abort the expansion.

Given these assumptions, CBO projects that constant dollar gross national product (GNP) will increase by 3.5 to 4.5 percent during 1978, slowing to 2.7 to 4.2 percent growth during 1979. This expansion of output is about what has typically been needed to keep the growth in employment in line with the growth in the labor force. As a result, the unemployment rate is not expected to improve much from its mid-1978 level, ranging between 5.2 and 6.0 percent by the end of the projection period. Meanwhile, prices are expected to continue to rise at a rapid rate, albeit below the double-digit pace during the first half of this year. The increase in the Consumer Price Index (CPI) for all of 1978 is forecast between 6.8 and 7.8 percent. Even in the absence of any unanticipated shocks, inflation is projected to remain very high next year, although somewhat below the 1978 rate.

SUMMARY OF ECONOMIC PROJECTIONS, CALENDAR YEARS 1978 AND 1979

Economic Variable	Rates of Change (percent)		
	1976:4 to 1977:4 (actual)	1977:4 to 1978:4	1978:4 to 1979:4
GNP (current dollars)	11.8	10.1 to 12.2	9.0 to 11.6
GNP (1972 dollars)	5.7	3.5 to 4.5	2.7 to 4.2
Consumer Price Index	6.6	6.8 to 7.8	6.2 to 7.2
End of Period (percent)			
Unemployment rate	6.6	5.5 to 6.1	5.2 to 6.0

Inflation Outlook

Consumer price inflation accelerated rapidly during the first half of 1978, rising at about twice the rate recorded in the final six months of last year. This upsurge was not because of widespread shortages of labor and capital. Rather, about 90 percent of the acceleration was associated with the simultaneous occurrence of three events: the jump in food prices resulting from adverse winter weather and depleted cattle herds, the decline in the foreign exchange value of the dollar, and the January hikes in payroll taxes and the minimum wage. While no comparable food and depreciation shocks are forecast for next year, the upward momentum of prices is projected to moderate only somewhat from the rapid 1978 pace. The principal factor causing this continued high level of inflation is expected to be rising labor costs--largely reflecting a catch up in wages to the acceleration of consumer prices earlier this year.

Reasons for the Slowdown

Both the foreign trade and state and local government sectors are expected to provide somewhat greater stimulus to economic

growth through the forecast period than they did last year. Consequently, the projected slowdown rests largely on the anticipated behavior of three sectors of the economy: housing, consumption, and business fixed investment.

- o Spending on residential construction is expected to slow from the present high rate because of the tightening of credit markets that had occurred by midyear; this tightening has already limited the funds available for home mortgages.
- o Consumer spending is likely to be constrained by the sharp increase in the ratio of personal debt to income and the reduced opportunity to liquidate equity in real estate caused by tighter mortgage markets. Moreover, consumer attitude surveys indicate the surge in retail sales earlier this year may have been in part to avoid future price increases; such buy-in-advance behavior "borrows" consumption from the future.
- o The recent Department of Commerce survey of business anticipations showed that constant dollar spending on plant and equipment is likely to continue to rise faster than overall growth but to increase less rapidly this year than in 1977.

Reasons for No Recession

Many forecasters believe that the anticipated slowdown in economic growth will turn into a recession. CBO agrees that the risks of a recession sometime in the projection period are substantial; however, given CBO's policy assumptions, CBO does not believe that, on balance, current economic trends point to a downturn, for the following reasons:

- o The tax cut included in the first concurrent resolution more than offsets the effects on disposable personal incomes of rising payroll taxes and of the rising income tax burden, caused by the combination of inflation and the progressive tax structure. Thus the tax cut should help sustain consumer spending. In addition, the tax package should provide some stimulus to business fixed investment.

- o The impact of higher interest rates on housing activity may be softened somewhat by the new regulations permitting lending institutions to pay market rates on deposits of \$10,000 or more.
- o The recent depreciation of the dollar should eventually help boost net exports.
- o There is little evidence of the imbalances between production and final sales that often precede a recession; indeed, throughout the current expansion, businesses have pursued a conservative inventory policy, keeping stocks closely aligned with sales.

These factors, however, do not touch upon the principal difference between the CBO projection and those that forecast a near-term recession: the future course of monetary policy. CBO simply assumes no significant further tightening of credit markets. By contrast, many forecasters anticipate a recession brought on by a credit crunch, as the Federal Reserve continues to raise interest rates in response to the acceleration of inflation and the rapid increase in the basic money supply.

POLICY OPTIONS

The first concurrent resolution enacted by the Congress last spring included a sizable tax cut to ensure continued economic growth. If such a tax cut is adopted, fiscal policy would be about as expansive in fiscal year 1979 as this year. The Congress now has an opportunity to review that earlier decision in the light of changing economic conditions.

Restrictive Fiscal Policy Options

If the Congress feels that the first concurrent resolution policy provides too much stimulus--particularly in light of the recent acceleration of inflation--it can take steps to reduce the fiscal year 1979 deficit:

- o One way would be to forego all or part of the \$15 billion tax cut for fiscal year 1979. If the tax cut were dropped, real output would be about three-fourths of one percentage

point lower by the end of 1979 and the unemployment rate about two-tenths higher. The restrictive effect would be larger at the end of 1980. By that time, prices might be 0.2 percent lower with the impact still incomplete since inflation reacts to fiscal policies more slowly than unemployment.

- o A significant restrictive economic effect could also be attained by cutting expenditures. If the Congress could achieve a cut in spending of \$10 to \$15 billion beyond the estimated shortfall, the effect on economic activity would be roughly similar to that described above for eliminating the \$15 billion tax cut, depending on the composition of the reductions.

While such a reduction in fiscal stimulus could lessen the risk of added inflation, real growth appears to be slowing, and there is a substantial danger that monetary and fiscal policies will become restrictive simultaneously--a shift that in the past has generally been followed by recession.

Expansive Fiscal Policy Options

In contrast to these restrictive measures, the Congress has before it a proposal (H.R. 8333, the Kemp-Roth Tax Reduction Act) for large tax cuts over a period of three years without comparable reductions in spending. The first-year tax cut--about \$6 billion more in fiscal year 1979 than that included in the first concurrent resolution--does not appear to be so large as to generate widespread excess demand, but the commitment to large future tax cuts involves a substantial risk. Conventional economic analysis indicates that such a policy could be highly inflationary during the second and third years, because it would sharply increase the budget deficit during a period when the economy might be reaching full employment. Experience has shown that it is extremely difficult to wring inflation out of the economy once it gets started.

In contrast to the conventional analysis, some of the proponents of this policy option contend that the deficit would not rise. They argue that large tax cuts increase incentives to work, save, and invest to such an extent that the cuts would pay for themselves in the first or second year and, therefore, would not be inflationary. CBO does not know of any empirical evidence for the view that the supply-increasing effects of tax cuts are so

large and so quick. The available evidence indicates that the stimulative effects of most tax cuts occur primarily through increased aggregate demand and that these effects are not large enough for the reductions to be self-financing.

Other Policies

The aggregate fiscal actions described above are not the only tools available to the Congress for reducing inflation and sustaining economic growth. Some others are described briefly here:

- o Payroll taxes could be reduced instead of income taxes. The CBO analysis indicates that, while cuts in payroll taxes and income taxes have about the same effects on real output and employment per dollar of tax cut, the effect on prices is more favorable with payroll taxes. A \$10 billion cut in payroll taxes will reduce the price level by about 0.3 percent after eight quarters, while an equal size cut in personal income taxes will increase the price level by about 0.1 percent, according to CBO estimates. Of course, there are other important considerations that may rule out reductions in social security taxes, such as the objective of keeping the financing of the social security system separate from the rest of the budget.
- o Better coordination of macroeconomic policy could be achieved. In addition to avoiding excessive shifts of monetary and fiscal policies in the same direction, improved coordination might result in a more desirable mix of policies. The long-run performance of the economy might be improved by a tighter fiscal policy and an easier monetary policy. The result might be smaller federal deficits combined with lower interest rates--conditions that might increase investment and ease future inflation by adding to industrial capacity.
- o The Congress might enact additional structural measures to improve the tradeoff between inflation and unemployment. Increased skill training as well as public jobs programs could help reduce the high unemployment rate. At the same time, a variety of measures could be used to reduce inflation, including the reform of government regulations, the reduction of the minimum wage for young workers, and the vigorous promotion of free international trade. Western

industrial economies also have frequently employed incomes policies to place direct restraint on inflation; in the United States, tax-based incomes policies have been receiving increasing attention.

CONCLUSION

Past experience indicates that monetary and fiscal policies have little capability for dealing with high inflation without incurring substantial costs in terms of output and employment. This limitation of macroeconomic policies suggests that, in the present circumstances, it would be useful to investigate closely other measures, such as policy composition and structural programs, that could eventually improve the tradeoff between inflation and unemployment. Such structural improvements, however, are not a panacea for the current economic ills, and the near-term resolution of the inflation-unemployment dilemma still will depend on whether the Congress, the Administration, and the Federal Reserve give greater emphasis to inflation or to sustaining economic growth.

For most of the period since the 1975 recession, monetary and fiscal policies have been moderately expansive. The excess capacity in the economy allowed a gradual reduction in unemployment without adding substantially to inflationary pressures. There is little doubt that these expansive policies have contributed to the reduction in unemployment from nearly 9 percent three years ago to 5.7 percent in June. For a time, during 1976, there appeared to be some reduction in the rate of inflation as well. But this proved to be temporary, and it is now evident that there has been little improvement in the underlying rate of inflation since the trough of the recession. Indeed, the inflation rate accelerated in the last six months and, although this upsurge did not reflect widespread shortages, many forecasters expect it to cause a lagged acceleration in wage gains which, in turn, will add to the existing inflationary momentum.

THE CURRENT POLICY DILEMMA

At the same time that inflation has accelerated, the economic expansion is showing signs of slowing. Despite the recent drop, unemployment rates are still high by postwar standards, and most forecasters project little improvement in the jobless rate in the months ahead, while some foresee a deterioration. But if these forecasts prove too pessimistic and the unemployment rate continues to drop rapidly, the availability of unused productive capacity that has held down the inflationary effect of expansive policies so far in the upswing would be eliminated. Moreover, there is uncertainty about the level of unemployment at which inflationary pressures begin to mount. Thus, policymakers face a most difficult dilemma. On the one hand, the standard fiscal and monetary policy remedies for inflation may weaken economic growth and, perhaps, trigger a new recession. On the other hand, expansive policies designed to sustain the expansion and reduce unemployment further could worsen inflation.

THE INFLATION-UNEMPLOYMENT TRADEOFF

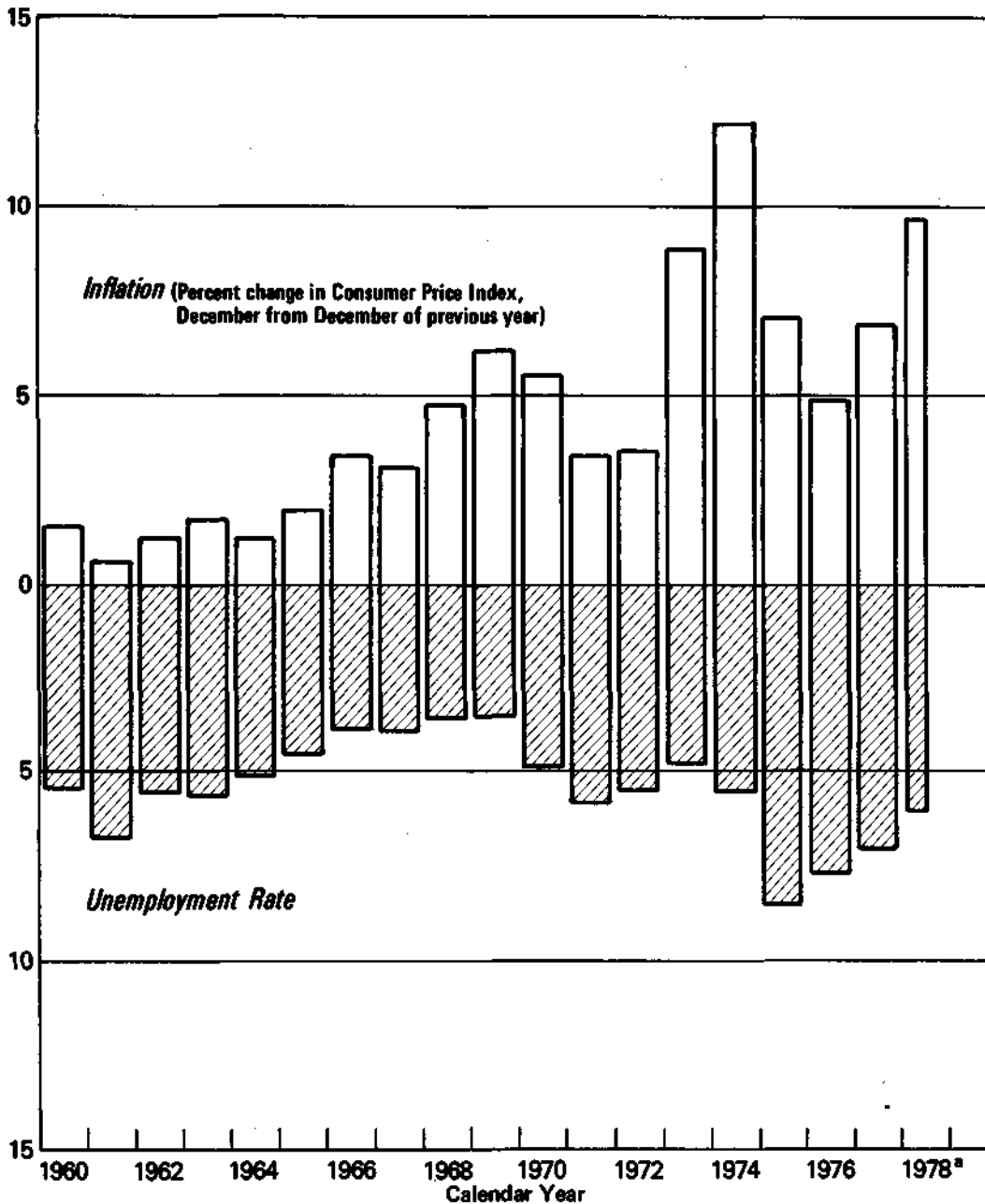
The traditional view about the relation between inflation and unemployment was that inflation would subside significantly in a period of high unemployment and excess capacity. The experience of the 1970s suggests, however, that high unemployment and excess capacity have not been effective in reducing inflation.

As shown in Figure 1, the combination of inflation and unemployment has reached very high levels in recent years. Upward price momentum has proven to be relatively insensitive to economic slack. The persistence of inflation makes the prospective cost of reducing it through macroeconomic policies high in terms of lost production and unemployment; conversely, expansive policies to reduce unemployment could generate even faster price increases. Furthermore, as a result of the momentum of inflation once started, the tradeoff is not symmetrical; unemployment responds much more quickly to fiscal and monetary policies than do prices. Most models estimate that unemployment rates would have to remain high for many years to reduce inflation to the levels experienced in the 1960s. While the benefits of attaining such a reduction in inflation could be significant, they need to be balanced against the loss of output and employment over a long period of time.

THE REPORT

In addition to the inflation-unemployment dilemma, the choices of policymakers are made more difficult by the uncertainty that exists in the economic outlook. The second chapter of this report reviews recent economic trends and presents the CBO forecast. The third chapter examines the problem of inflation. The final chapter presents several policy options that are available to the Congress for dealing with the problems of unemployment and inflation.

Figure 1.
Inflation and Unemployment
Percent



SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

NOTES: Inflation rates are plotted above the zero line and unemployment rates below. The increase in the total height of the bar indicates the worsening of the inflation-unemployment tradeoff.

^a1978 data are for first half of year. Inflation data partly estimated by CBO.

CHAPTER II. THE ECONOMIC OUTLOOK

Based on the assumptions outlined below, CBO expects real gross national product (GNP) to grow at a 3.5 to 4.5 percent rate during 1978, slowing to a 2.7 to 4.2 percent rate during 1979. The unemployment rate will be little changed at a rate between 5.2 and 6.0 percent at the end of 1979. Assuming there are no unanticipated price shocks, the inflation rate is expected to be between 6.8 and 7.8 percent during 1978, subsiding somewhat to between 6.2 and 7.2 percent during 1979. (See Table 6 on page 27.)

For the purposes of this forecast, CBO made the following policy assumptions:

- o Fiscal policy is as given in the First Concurrent Resolution on the Budget for Fiscal Year 1979, with the \$15 billion tax cut contained in that resolution.
- o For monetary policy, it is assumed that short-term interest rates will not rise much further and that credit conditions will not become so restrictive as to abort the expansion.

The expected slowdown in real economic activity in 1979 is largely the result of the recent acceleration of inflation and of credit tightening by the Federal Reserve. Many economic forecasters now expect a sharper slowdown--or even a recession--during the next year or two, arising from further tightening by the Federal Reserve. The CBO forecast of a moderate rather than a severe reduction of growth during 1979 depends critically on the assumption that the monetary authorities will not allow short-term interest rates to rise much further--certainly not to the point at which there is a substantial movement of funds from thrift accounts, which finance housing, into higher-yielding short-term market instruments.

The behavior of the Federal Reserve assumed in the CBO forecast is by no means certain to occur. The recent acceleration of inflation and the growth of the narrowly defined money stock (M1)--currency and checking accounts--above the Federal Reserve's announced targets places the monetary authorities in a difficult position. The Federal Reserve does not want to validate inflation

by permitting growth in money aggregates above target ranges. ^{1/} But, because of the strong momentum of inflation, real economic activity tends to respond more quickly than inflation to tight credit conditions. Therefore, if monetary authorities increase short-term interest rates much beyond current levels, CBO anticipates a sharp slowdown in activity, with rising unemployment--and perhaps even a recession, depending on the severity of the credit restraint. Inflation would slow, although this effect would be relatively small and occur later, with little perceptible effect during the forecast period.

Aside from a possible credit squeeze, there now appear to be few other sources of major weakness in the economy. Fiscal policy is moderately stimulative in the current fiscal year and will remain so in fiscal year 1979 if the policies of the first concurrent resolution are not altered significantly. The state and local government sector of the economy is likely to be more stimulative over the next few years than it has been recently. Underlying demands by consumers and business generally seem to be sufficient to maintain growth at moderate rates, and there are few signs of the excesses in inventories that frequently precede a drop in production.

The first section of this chapter reviews recent developments in fiscal and monetary policies in more detail. The second and third describe current trends in major components of nonfederal demand, and in output, employment, and prices. The final section presents CBO's forecast, the policy assumptions on which the forecast is based, and the major sources of uncertainty associated with the forecast.

^{1/} Historical relationships suggest that the Federal Reserve would be required to violate its M1 targets in order to achieve the growth rates shown in the CBO forecast. However, a new Federal Reserve rule that would permit commercial banks to transfer funds automatically from savings accounts to checking accounts beginning next November may alter these relationships, at least temporarily. Unless the Congress or the courts overturn this rule change, depositors are expected to reduce their checking accounts and increase savings accounts, which would reduce the growth rates of M1 but not of M2. The size of the effect is uncertain and hence M1 growth rates will be difficult to interpret during this transition period.

RECENT TRENDS IN FISCAL AND MONETARY POLICIES

Fiscal Policy

In the spring of 1977, with the unemployment rate hovering around 7 percent, the Congress enacted several budget measures to boost the economy. This stimulus, which mainly involved tax cuts but also included some spending measures, helped maintain economic growth and reduce unemployment during the past year. Largely because of these measures, the budget deficit is expected to increase somewhat in the current fiscal year (1978) over fiscal year 1977, as shown in Table 1.

TABLE 1. UNIFIED BUDGET ASSUMPTIONS: BY FISCAL YEARS, IN BILLIONS OF DOLLARS

	1977 (actual)	1978 (CBO estimate)	1979 a/ (CBO estimate)
Outlays	402	451	495
Receipts	357	398	446
Deficit (-)	-45	-53	-49

a/ Based on First Concurrent Resolution for Fiscal Year 1979. Beginning in 1979, earned income credit payments in excess of an individual's tax liability are treated as outlays rather than as income tax refunds in accordance with the convention adopted by the Budget Committees in the first resolution.

Fiscal Year 1978. Total federal expenditures are projected to grow about 10.3 percent (on a National Income Accounts [NIA] basis) in fiscal year 1978, below the 11.6 percent annual average growth rate of the previous five fiscal years (see Table 2). But purchases of goods and services are expected to rise more rapidly this fiscal year than the five-year trend increase. In addition, the stimulus undertaken in the spring of 1977 added funds for grants

to state and local governments, such as countercyclical revenue sharing, public works, and public service employment. In contrast, transfer payments to individuals in this fiscal year will grow more slowly than the recent trend, as the decline in unemployment and the expiration of some special unemployment insurance provisions reduce outlays.

TABLE 2. FEDERAL EXPENDITURES GROWTH, NATIONAL INCOME ACCOUNTS
BASIS: BY FISCAL YEARS, PERCENT CHANGE

	Average Annual Growth, 1972 to 1977 <u>a/</u> (actual)	1978 (CBO estimate)	1979 (CBO estimate)
Total Expenditures	11.6	10.3	9.8
Purchases of Goods and Services	6.7	8.9	9.7
Domestic Transfer Pay- ments to Individuals	16.2	7.7	9.5
Grants to State and Local Governments	14.4	14.1	10.0
Other <u>b/</u>	9.7	20.7	11.5

a/ Adjusted for transition quarter between fiscal years 1976 and 1977.

b/ Transfers to foreigners, net interest paid, subsidies less current surpluses of government enterprises, and wage accruals less disbursements.

Federal revenues are expected to be reduced by about \$18 billion in fiscal year 1978 as a result of last year's tax cuts. The standard deduction for the personal income tax was increased, causing lower withholding after mid-1977 and extra refunds in early 1978. Revenue growth is also being held down by the extension

through 1978 of tax reductions that had been enacted previously--the general personal income tax credit, the 10 percent earned income credit for low-income families with dependents, and a decrease in the corporate tax rate for corporate incomes within certain ranges. Last year's stimulus package also included an employment tax credit with limited subsidies to firms increasing employment levels.

The reduction in federal personal income taxes has offset much of the increase in effective tax rates caused by inflation and real growth. At the same time, social insurance taxes--payroll taxes for social security and unemployment insurance--have taken a slightly higher share of income because of legislated increases in both tax rates and tax bases.

Fiscal Year 1979. Federal spending in fiscal year 1979 will increase at about the same rate as in fiscal year 1978, assuming no change from the first concurrent resolution policies. This resolution includes a \$15 billion cut in taxes, beginning in January 1979, that will more than offset the impact in 1979 of the scheduled increases in social security taxes and of the upward drift of effective tax rates caused by the interaction of inflation and the progressive income tax structure.

Fiscal policy is expected to be moderately stimulative in both fiscal years. One measure of the effects of the budget on the economy is the "full-employment budget"--that is, the budget as it would be with full employment, which would increase federal revenues and decrease outlays for programs such as unemployment insurance. Using the full-employment budget, fiscal stimulus increased in fiscal year 1978, largely because of the measures mentioned earlier. In fiscal year 1979, the federal sector would provide slightly more stimulus if the full tax cut and other measures of the first resolution were enacted, including extension of the temporary tax cuts made in 1977. The quarterly pattern shown in Table 3 indicates a trailing off of stimulus in the second half of fiscal year 1978, followed by a spurt in early fiscal year 1979, caused by a step up in expenditure growth in the last quarter of 1978 and the tax cut that takes effect in the first quarter of calendar year 1979. Thereafter, the budget position remains about unchanged, with the full-employment deficit fluctuating narrowly around \$20 billion. Without the tax cut, the full-employment budget would swing to near balance in the second half of the fiscal year, a significantly less stimulative position.

TABLE 3. FULL-EMPLOYMENT BUDGET ESTIMATES, FISCAL YEARS (FY)
1972 TO 1979: IN BILLIONS OF DOLLARS, ANNUAL RATE

	Full-Employment Expenditures	Full-Employment Revenues	Full-Employment Deficit (-) or Surplus (+)
FY 1972	230.1	223.8	-6.3
FY 1973	255.6	243.3	-12.3
FY 1974	277.5	276.6	-0.9
FY 1975	322.6	315.9	-6.7
FY 1976	360.6	349.2	-11.4
FY 1977	401.5	387.0	-14.5
<hr/>			
<u>Fiscal Year 1978</u>			
1977:4	439.8	409.7	-30.1
1978:1	446.6	427.8	-18.8
1978:2	451.5	441.5	-10.0
1978:3	463.5	450.9	-12.6
FY 78	450.4	432.5	-17.9
<hr/>			
<u>Fiscal Year 1979</u>			
(Assuming policy in the First Concurrent Resolution for FY 1979) a/			
1978:4	480.2	462.5	-17.7
1979:1	491.7	468.4	-23.3
1979:2	500.0	480.8	-19.2
1979:3	513.9	491.5	-22.4
FY 79	496.5	475.8	-20.7

a/ The CBO estimate of actual spending in fiscal year 1979 is \$499.2 billion (NIA basis), \$4.5 billion less than the amount in the first concurrent resolution. If a spending shortfall greater than that forecast by CBO occurs, full-employment expenditures will be below the levels shown in the table and the stimulus provided by the federal sector will be reduced from that shown.

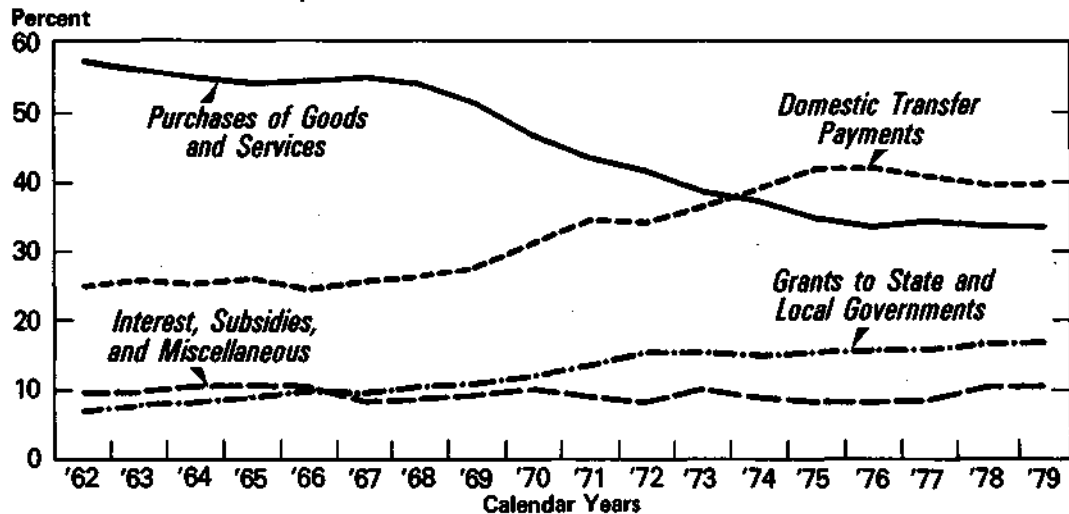
Both the actual and full-employment federal deficits for fiscal years 1977 and 1978 are seen by many as unusually large for the second and third years of a cyclical recovery. Even so, these deficits have not yet produced a high-employment economy such as occurred in 1968 or 1973, when full-employment deficits were also sizable. What is the explanation for this difference?

- o First, of course, the size of the economy and the price level have grown, so that today's deficits are relatively smaller.
- o Second, a changed composition of federal expenditures means that stimulus per dollar of deficit is less today than in the 1960s and early 1970s. Many studies indicate that changes in federal purchases have a larger impact on the economy per dollar of expenditures than do changes in transfer payments to individuals or grants to states and local governments. As shown in Figure 2, federal purchases have declined sharply as a proportion of total federal spending since the late 1960s. The rapid growth of transfer payments in recent years partly reflects the automatic response of such programs as unemployment insurance benefits and social security payments to increases in claims and the rising cost of living. A number of new grant programs, such as countercyclical revenue sharing, were also enacted in recent years to offset the effect of the recession.
- o Finally, the international and state and local government sectors of the economy were not a drag on the economy in earlier years, as they have been recently. Large trade deficits and large surpluses run by state and local governments have tended to offset the stimulative effects of recent federal deficits. (The surpluses accruing to foreigners and state and local governments also provide funds to finance the increase in the federal debt.)

Monetary Policy

The growth in the narrowly defined money stock (M1)--currency and checking accounts--has been quite high during the last year because rapid growth in current dollar income, boosted by inflation, pushed up the demand for money for transaction purposes.

Figure 2.
Federal Expenditures by Type, as a Percent
of Total Federal Expenditures

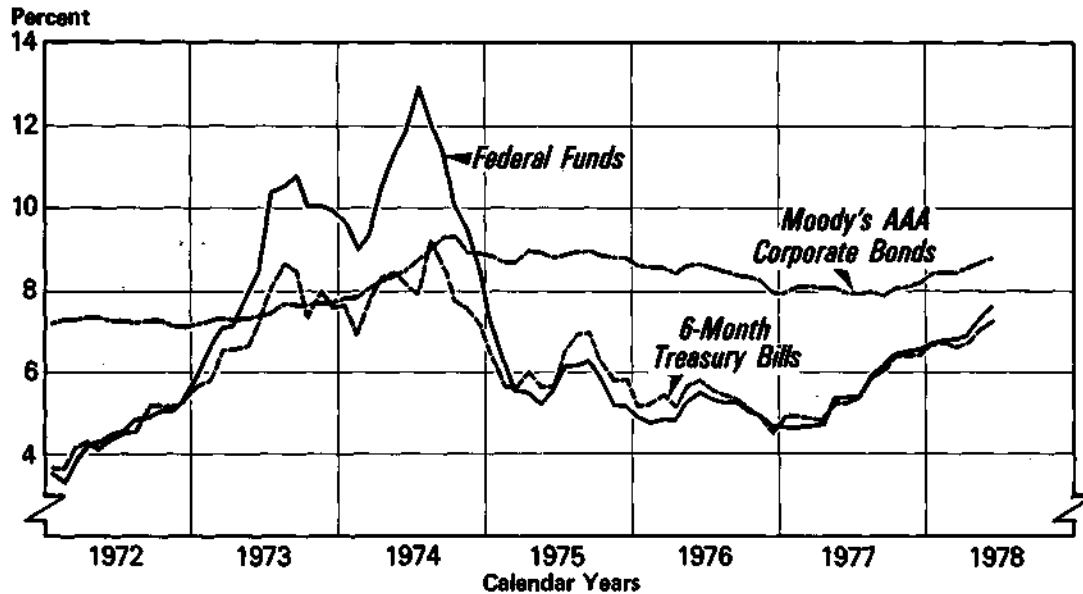


SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis for historical data, CBO estimates for 1978 and 1979; those for fiscal year 1979 based on First Concurrent Resolution for Fiscal Year 1979.

The growth in M1 over the last year has been about 8 percent, well above the Federal Reserve's 4.0 to 6.5 percent target range. However, the growth of M2 (M1 plus savings deposits) has been within its target range of 6.5 to 9 percent, as high interest rates reduced the flow of savings deposits. Although the Federal Reserve has responded to this situation by periodically raising its interest rate targets on federal funds, it has not been successful in bringing down the growth of M1 to the target range.

As a result of Federal Reserve policy and rising money demands, interest rates have been moving up steadily for about 18 months. For example, the six-month Treasury bill rate increased from 4.8 percent to 7.4 percent since the beginning of 1977. Longer-term interest rates have also risen significantly, as shown in Figure 3.

Figure 3.
Interest Rates



SOURCE: Board of Governors, Federal Reserve System.

Despite the relatively moderate growth in M2, which is more closely related to current dollar GNP than M1, some interpret the recent expansion of money (M1) above the Federal Reserve target range as an indication that monetary policy has been expansive. Treasury bill rates have increased sharply, however, as the Federal Reserve attempted to reduce the growth of M1 to its target range. In the short run, such increases in short-term market rates can reduce net new deposits in savings accounts and thus reduce the availability of credit for housing. Thus, in terms of credit conditions and the short-run impact on economic activity, recent Federal Reserve actions represent a significant tightening.

TRENDS IN NONFEDERAL DEMAND

On balance, macroeconomic policy has supported substantial growth over the past year. A significant impetus to the growth in economic activity in 1977 and in the first half of 1978 came from the stimulative fiscal measures described earlier in this chapter. Moreover, because of the lags between changes in monetary policy and their impact on economic activity, the tightening of credit conditions that had occurred by mid-1978 has as yet had only limited impact on economic growth.

Recent quarterly changes in real (constant dollar) final sales--a measure of the strength of demand--are shown in Table 4. Although final sales in the first quarter of this year were quite weak, this is a misleading indicator of the strength of the economy at the turn of the year. A particularly harsh winter and a prolonged coal strike distorted patterns of production, employment, income, and spending. Available data indicate a sharp rebound of sales in the second quarter.

TABLE 4. CHANGE IN FINAL SALES AND ITS MAJOR COMPONENTS: PERCENTAGE CHANGE, CONSTANT DOLLARS, SEASONALLY ADJUSTED ANNUAL RATE, BY QUARTERS OF CALENDAR YEARS

	1977				1978
	I	II	III	IV	I
Total Final Sales	3.8	5.1	4.4	6.1	-1.7
Personal Consumption Expenditures	5.1	1.8	3.0	9.3	-0.9
Fixed Investment	14.7	16.8	2.5	8.1	1.5
Residential	5.4	42.6	-0.7	17.6	-3.9
Nonresidential	19.0	7.0	3.9	4.0	4.1
Government Purchases	-1.9	10.6	6.1	4.3	-3.8
Federal	-0.3	18.2	8.9	3.4	-9.1
State and Local	-2.8	6.3	4.4	4.9	-0.4

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

At mid-year, however, there are gathering signs that the underlying strength of the expansion may be waning, particularly if monetary policy becomes increasingly restrictive.

Personal Consumption

Since the beginning of 1977, personal consumption expenditures have risen about as fast as total final sales. This recent behavior is in marked contrast to the first year and a half of the recovery when consumer spending provided significant impetus to the expansion of overall economic activity.

During the second quarter of this year, retail sales rebounded sharply from the weather-depressed pace of the first quarter, rising at an 18 percent annual rate in current dollars--a substantial gain even after allowing for large price increases. Besides making up for purchases that were postponed earlier in the year, the recent burst in consumer spending was also the result of at least two other factors. First, employment has been increasing at an exceptionally rapid pace. Total employment, as measured by the monthly household survey, rose by nearly 2 million between January and June, and the consequent addition to consumers' incomes contributed to their recent buying surge. Second, inflation accelerated sharply from its rate during the second half of 1977, apparently convincing a number of consumers to buy early. Surveys of consumer attitudes show that a rising proportion of respondents believe that now is a good time to buy because prices are expected to go higher in the future.

A buy-in-advance psychology, of course, affects primarily the purchases of durable goods, and recent data on auto sales suggests that consumers are acting on their opinions about prices. These sales were at annual rates of 11.9 million cars in June and 11.4 million cars in the first six months of this year, just about the same as in the corresponding period last year when purchases were rebounding after the Ford strike. If this current strength in consumer spending is indeed based on buy-in-advance sentiment, it is likely to be temporary.

In addition to the lull after buy-in-advance purchases, a number of other factors are likely to retard the growth of consumer spending later this year and in 1979. The recent rapid rate of employment growth is not expected to continue. Furthermore, consumer debt considerations suggest that the saving rate may

rise, thereby slowing the growth of consumer spending. The ratio of consumer debt (excluding home mortgages) to personal income has been rising and is now above its 1974 high. Other measures of the debt burden remain below previous peaks but have been increasing; further indication of the rising debt burden can be found in a recent rise in installment loan delinquency rates. Finally, if higher interest rates reduce the turnover of existing houses as well as the construction of new ones, this may reduce the capital gains that homeowners have been able to realize--and spend--when selling houses, providing another reason for a rising saving rate and less impetus from consumption.

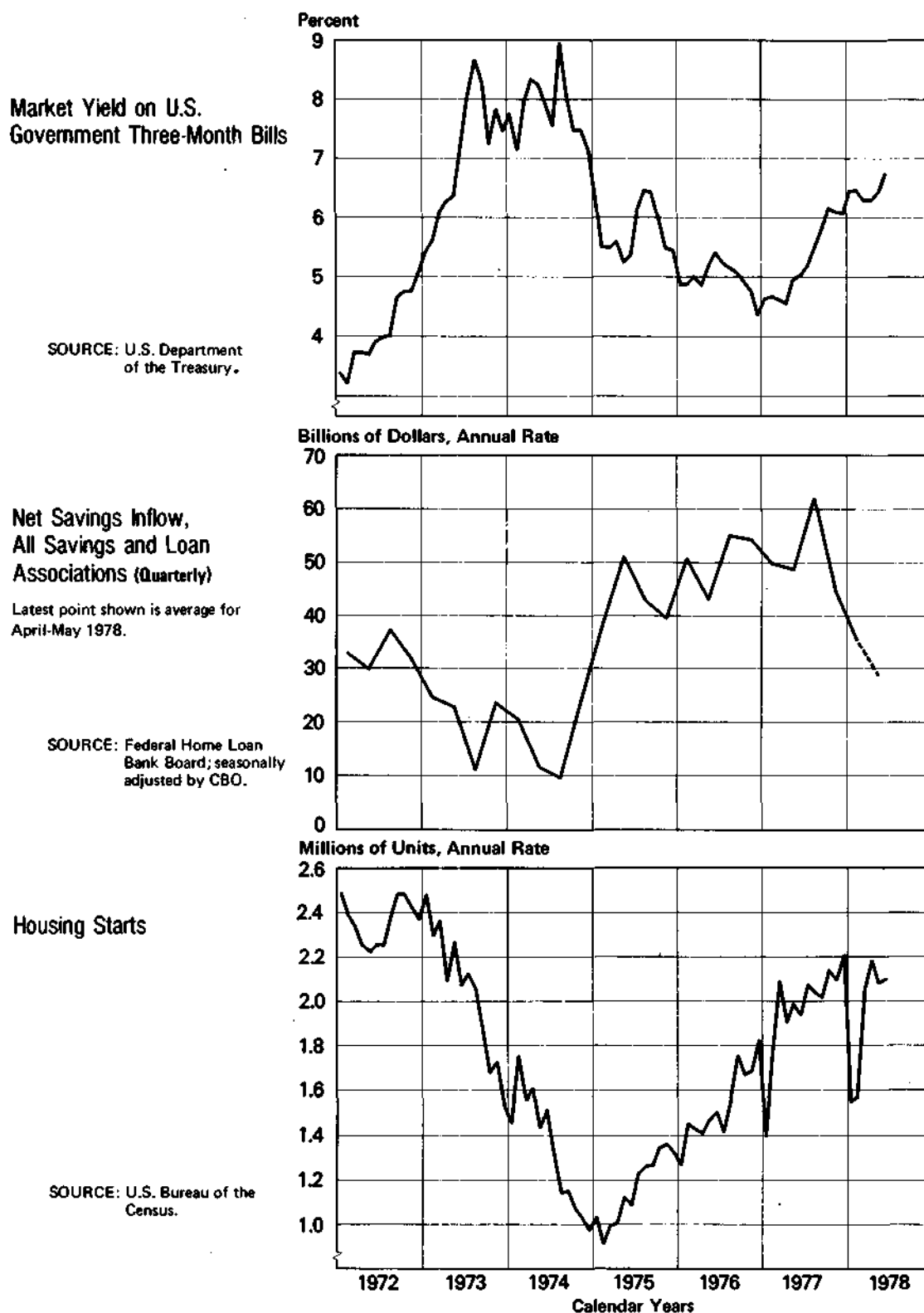
The scheduled social security tax rise and continued fiscal drag associated with personal income taxes (that is, rising tax rates resulting from a progressive tax structure in a period of rapid current dollar income growth) would normally also retard the growth in disposable income and dampen consumer spending. These effects, however, are offset by the personal income tax cuts specified in the first concurrent resolution.

Housing

For 1977 as a whole, spending on residential construction was a significant source of strength for total final demand. Housing starts were nearly 2 million units last year--well above the 1.5 million recorded in 1976. Although starts were depressed by severe winter storms in the first two months of this year, they have rebounded sharply in subsequent months; the 2.1 million unit annual rate in May was one-fifth greater than the first-quarter average. As a result, spending for housing provided significant impetus to the strength of final demand in the second quarter.

After midyear, however, the prospects for the housing sector become less bright; the probable slowdown will result largely from the recent rapid increase in interest rates described earlier in this chapter. In part, rising mortgage rates, along with rising land and other housing costs, may price some households out of the market. But more important, sharply higher short-term interest rates will limit the funds available for financing house purchases. In the past, when short-term rates (top panel, Figure 4) have risen significantly above rates paid on savings accounts, net new flows of funds to savings and loan associations and mutual savings banks, the main sources of housing finance, have dwindled (middle panel, Figure 4). In turn, housing starts tend to decline when savings flows fall, as the bottom panel of Figure 4 shows.

Figure 4.
Interest Rates, Savings Flow, and Housing Starts



If past relationships hold, residential construction activity is likely to slow markedly by the end of 1978. Signs of credit-market tightening are already apparent. In the first five months of 1978, net inflows at savings and loan associations were 29 percent below a year earlier. While these institutions have been able to reduce their liquidity and borrow from other sources, mortgage lending has already declined significantly; by May, commitments outstanding for future mortgage lending had fallen for five consecutive months on a seasonally adjusted basis.

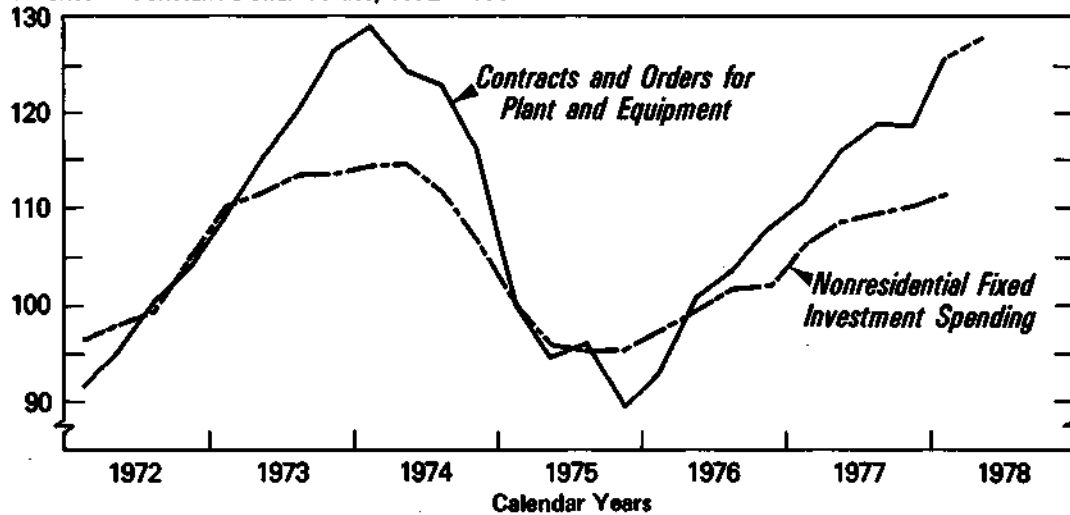
Starting June 1, savings associations have been allowed to offer new saving certificates that bear interest rates competitive with Treasury bills. First indications are that over half of the funds for these new instruments came from other savings at the same institutions. Thus, they may serve to prevent further declines in inflows but not necessarily provide the upturn in savings flows necessary to finance a relatively high level of housing starts.

Business Fixed Investment

Although business fixed investment rose faster than total final sales in the last year and a half, spending on new plant and equipment continues to fall considerably short of its typical postwar performance during economic expansions. This moderate performance will probably persist throughout the remainder of 1978. According to the latest Commerce Department survey, business intends to increase current dollar spending for fixed investment by 11.2 percent in 1978, up only slightly from the previous survey, suggesting some slowdown in the real growth from 1977. Contracts and orders for plant and equipment (see Figure 5) indicate near-term strength in this spending category but do not guarantee that it will continue, since this series does not presage long leads on investment spending.

Continued economic expansion depends importantly on substantial growth in spending for fixed capital expansion; furthermore, a rising capital stock contributes to the advance in labor productivity and higher living standards. Consequently, the relative weakness in this sector in the recent recovery is a matter of

Figure 5.
Investment Orders and Spending
Indexes of Constant Dollar Values, 1972 = 100



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: The index of contracts and orders is a two-quarter moving average placed at the second quarter. The preliminary figure for the second quarter of 1978 is an average of first quarter 1978 and the April-May average.

special concern. Economists offer several related reasons for the relatively poor performance of business fixed investment, including the following:

- o Capacity utilization in manufacturing has increased very little over the past year, and remains below the rate that is expected to induce capital expansion. Furthermore, there is substantial excess capacity in Europe and Japan, where the recoveries from the mid-1970s recession have been relatively weak.

- o The rate of return on capital is low, partly because federal tax law requires depreciation to be charged at historical cost, which overstates taxable profits during inflation. Since the prospective rate of return is obviously an important factor in deciding to undertake a capital project, the existing low returns depress investment activity.
- o Business firms find it difficult to plan for the future in an atmosphere of rapidly rising prices and uncertainty as to the future course of government regulation, energy prices, and macroeconomic policy.
- o Reflecting the previously mentioned factors, the stock market has been quite depressed. At the same time, the prices of new construction and equipment have risen rapidly. Together these factors make it more profitable to buy existing facilities than to invest in new plant and equipment, thus decreasing spending on fixed capital.

It is not clear why there has been such a shortfall in business fixed investment over the last few years; the answer is probably some combination of the factors listed above, and perhaps others as well. As a result of the uncertainty about the cause of the relative weakness in this sector, it is difficult to assess its prospects for 1979. It is possible that the second-quarter strength in output will lead to higher capacity utilization and higher profits, which could cause businesses to revise their investment plans upward. On the other hand, tight credit and higher interest rates would reduce investment spending, though not so quickly and dramatically as they reduce housing activity.

International Trade

In recent quarters, constant dollar exports have changed little while imports have risen. The increase in imports was particularly sharp in early 1978, as cold weather and the coal strike raised oil demand, and steel imports were accelerated to make purchases before the new reference price system, which raises the prices of imported steel, became effective. The current dollar trade and services balance deteriorated even more sharply, as the depreciating dollar was reflected in accelerating import prices.

The lagged effects of the earlier depreciation of the dollar may begin to be felt in expanded real volume of exports and a slowing volume of imports. With the reference price system in effect, a reduction in steel imports can also be expected. Ultimately, however, the future course of net exports will depend heavily on the recoveries of economies abroad and on whether the United States enacts a program to reduce oil imports (and the design of such a program).

State and Local Governments

State and local government spending, aided by federal grants for public service employment and public works, expanded strongly in real terms in the final three quarters of 1977, but levelled off in the first quarter of 1978 as unusually bad weather inhibited construction activity. A strong spending rebound probably occurred in the second quarter. Federal grants are expected to peak at the end of calendar year 1978 and provide little stimulus thereafter.

State and local government receipts have continued to outpace spending, however, and the combined operating surpluses ("other funds") of these governments have risen sharply since 1976 (see Table 5), with the net result that this sector too has retarded growth in the economy. For some time, observers of state and local fiscal patterns have speculated that the trend of rising operating surpluses would be reversed. The passage of Proposition 13 in California's June election suggest that the reduction of these surpluses may be about to begin and that it may take the form of reduced taxes rather than increased spending. The impact of Proposition 13 on national economic activity, however, is likely to be very small, unless it is the first of a series of similar measures enacted in numerous states. 2/

2/ The most significant impact of Proposition 13 is on prices. The national rate of inflation is estimated to be 0.2 percentage points less in 1978 and in 1979 as a result of Proposition 13. For further details, see CBO, Proposition 13: Its Impact on the Nation's Economy, Federal Revenues, and Federal Expenditures, Background Paper (July 1978).

TABLE 5. STATE AND LOCAL GOVERNMENT RECEIPTS AND SPENDING: BY CALENDAR YEARS, IN BILLIONS OF CURRENT DOLLARS

	1976	1977	Percent Change, 1977 from 1976	1977				1978
				I	II	III	IV	I
Receipts, Total	264.7	294.4	11.2	281.0	288.1	301.6	307.1	313.8
Taxes and social insurance con- tributions	203.7	227.0	11.4	219.0	224.5	228.9	235.4	239.1
Federal grants-in-aid	61.0	67.5	10.7	62.0	63.6	72.7	71.7	74.7
Expenditures	246.2	265.2	7.7	253.7	262.6	268.7	276.0	279.6
Surplus or Deficit, Total	18.4	29.2	58.7	27.3	25.4	32.9	31.1	34.1
Social insurance funds	14.5	15.5	6.9	15.4	15.5	15.5	15.7	16.0
Other funds	3.9	13.7	251.3	11.9	10.0	17.4	15.4	18.1

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

Inventories

Business inventories were kept in fairly close alignment with sales during 1977 and early 1978, and in real terms the inventory/sales ratio changed little and remained relatively low. Evidently anticipating a strong second quarter, businesses maintained production levels and increased employment during the first-quarter slowdown in sales, rebuilding stocks after a fourth quarter in which sales gains outstripped additions to inventories. Low ratios of inventories to sales and to unfilled orders early in the second quarter were expected to encourage further stockbuilding during the quarter.

As sales gains slow in succeeding months, the rate of inventory investment will probably subside, if businesses continue to bring inventories in line with sales as quickly as they have in the past two years. Hence, inventory stimulus to output should end around midyear. Recent business caution with respect to inventory stockbuilding has apparently prevented the widespread imbalances that have previously contributed to sharp adjustments in production and employment when total demand weakened. The available evidence continues to show little indication of a speculative inventory boom like the one that accentuated the 1973 expansion and the 1974-1975 recession.

TRENDS IN EMPLOYMENT, PRODUCTIVITY, AND PRICES

Employment

Recent output increases have been accompanied by relatively large employment gains. From the second quarter of 1977 to the second quarter of 1978, the gain in real gross national product was about 4.4 percent. Over the same period, employment also rose 4.4 percent, as measured by both the household and establishment surveys. It is unusual for employment to rise as fast as output. Part of the explanation was a slight decline in the average work-week, possibly associated with a rise in part-time employment. Also, there was an expansion in the number of public service jobs, each of which provides fewer GNP dollars than the average private job.

Labor force growth over the past year also continued at a relatively high rate of 3.1 percent. But as a result of the faster employment growth, ^{3/} the unemployment rate declined more than a full percentage point, from 7.1 percent in the second quarter of 1977 to 5.9 percent in the second quarter of 1978, with the June rate unexpectedly low at 5.7 percent.

The decline in unemployment was not the same for all groups in the labor force. From the second quarter of 1977 to the second quarter of 1978, the white unemployment rate dropped from 6.3 to 5.1 percent, while the rate for nonwhites only fell from 12.8 to 12.0 percent, and the nonwhite/white differential rose to an unusually high ratio of 2.4:1. For nonwhite teenagers, the unemployment rate of 36.9 percent was little changed over the year, and, for women who head families, the rate actually rose, from 9.3 percent to 9.4 percent.

While these unemployment rates are evidence of continued problems for some labor market groups, they should not be interpreted as evidence that disadvantaged groups have failed to share in employment gains. In fact, employment gains for nonwhites over the year were 7.3 percent, nearly double the 4.0 percent rate of gain for whites. The reason the black unemployment rate fell so little was not a lower rate of job gain but a higher rate of labor force growth. This reflected both faster population growth and the return of previously discouraged workers to an active search for jobs.

Productivity

The growth in output per hour worked (productivity) is the principal source of rising living standards, and recent performance here has been disappointing. As noted above, employment growth over the past year has been nearly as rapid as the gain in output. The increase in labor productivity for the private nonfarm business sector was only 1 percent during the year ending in the first quarter of 1978, well below the 2.8 percent rise recorded during the previous four quarters. Preliminary indications are that

^{3/} Labor force measures both those who are employed and those who are actively looking for jobs.

productivity growth rebounded little in the second quarter, so that the first half of 1978 may have been characterized by further deterioration in a rate of productivity growth that was already weak by postwar standards.

A widely advanced explanation of the 1978 productivity deterioration is that firms have been hiring in anticipation of future output gains. If this is the case, it can be anticipated that from now on employment gains will slow and productivity increase. If, instead, the current low rate of productivity growth continues, higher rates of increase in unit labor cost will result, lowering profits and raising prices.

Prices

Consumer prices in the first five months of 1978 increased at about twice the rate recorded during the previous 6 months. This acceleration is examined in more detail in Chapter III; in brief, it can be attributed to higher food prices, government-mandated cost increases, and the depreciation of the dollar against the currencies of other major countries. Although the full effect of these factors on prices has not yet occurred, much of it has. Consequently, the rate of consumer price inflation is expected to decelerate in the second half of the year.

But inflation may well pick up speed again next year. Another round of minimum wage and payroll tax increases is scheduled. Energy prices may rise more rapidly than this year, especially if OPEC increases crude oil prices and if domestic action raising energy prices is taken. Perhaps most important, 1979 is a relatively big collective bargaining year, and the negotiating unions will be seeking to restore traditional real income growth eroded by the recent rapid rates of inflation. An analysis of the trend in real income lost over the past three years by workers in the auto, rubber, electrical machinery, and trucking industries, despite cost-of-living escalator clauses, indicates that increases in life-of-contract (three-year) wage settlements could run 30 percent or more in 1979. Such wage adjustments would clearly be well above probable productivity gains as well as above recent average rates of wage increase, and hence they would contribute to the continued momentum of inflation.

PROJECTIONS FOR 1978 AND 1979

Monetary and Fiscal Policy Assumptions

The CBO forecast of the economy through 1979 is based on the following assumptions:

- o Federal outlays on a unified budget basis of \$451 billion in fiscal year 1978 and \$495 billion in fiscal year 1979. These figures represent shortfalls of about \$7 billion and \$4 billion, respectively, from the most recent budget resolutions.
- o A tax cut of approximately \$15 billion in fiscal year 1979 (\$20 billion annual rate) beginning next January. Personal tax cuts comprise roughly two-thirds of this amount with the balance consisting of reduced corporate taxes and a retroactive increase in the investment tax credit. The 1977 tax cuts are extended; all other tax legislation is assumed to be unchanged.
- o Little further rise in short-term interest rates.

As emphasized earlier, this course of monetary policy is only an assumption. The dilemma of the Federal Reserve, with accelerating inflation on one hand and the prospect of recession on the other, makes the outlook for monetary policy particularly uncertain. The probable response of the economy to an alternative, more restrictive, course of action by the Federal Reserve is given at the end of this chapter.

The Projection

Given the assumptions outlined above, the economy is expected to show moderate growth through 1978, with real gross national product in the final quarter of this year 3.5 to 4.5 percent above the fourth quarter of 1977. The projection is shown in Table 6. During 1979, the advance in real GNP is expected to slow, averaging between 2.7 and 4.2 percent. As a result, the unemployment rate is expected to be between 5.2 and 6.0 percent by the end of next year, a range that includes the June 1978 rate of 5.7 percent. Even if price increases moderate in the second half of 1978, the rate of consumer price increase for the year as a whole is expected to be between 6.8 and 7.8 percent, compared with

TABLE 6. ECONOMIC PROJECTIONS BASED ON CURRENT POLICY, CALENDAR YEARS 1978 AND 1979

Economic Variable	Levels			Rates of Change (Percent)		
	1977:4 (actual)	1978:4	1979:4	1976:4 to 1977:4 (actual)	1977:4 to 1978:4	1978:4 to 1979:4
GNP (billions of current dollars)	1962 <u>a/</u>	2160 to 2202 <u>a/</u>	2354 to 2457 <u>a/</u>	11.8	10.1 to 12.2	9.0 to 11.6
Real GNP (billions of 1972 dollars)	1360 <u>a/</u>	1408 to 1421 <u>a/</u>	1446 to 1481 <u>a/</u>	5.7	3.5 to 4.5	2.7 to 4.2
General Price Index (GNP Deflator, 1972=100)	144 <u>a/</u>	153 to 155 <u>a/</u>	163 to 166 <u>a/</u>	5.8	6.4 to 7.4	6.1 to 7.1
Consumer Price Index (1967=100)	185	198 to 200	210 to 214	6.6	6.8 to 7.8	6.2 to 7.2
Unemployment Rate (percent)	6.6	5.5 to 6.1	5.2 to 6.0	-	-	-

a/ Estimates do not reflect July 1978 revisions in GNP levels.

the 6.6 percent rate of increase from the fourth quarter of 1976 to the fourth quarter of 1977. Consumer price inflation is expected to moderate a little during 1979, rising 6.2 to 7.2 percent, as the effects of the recent food price run-up and dollar depreciation wane. ^{4/}

From a policy perspective, this projection raises two inter-related questions:

- o Why is the expansion of economic activity expected to slow down?
- o Why will this slowdown not turn into a recession during the forecast period?

Each question will be considered in turn.

Factors Contributing to a Slowdown. Even with luck, it will be difficult to maintain the pace of output expansion recorded in 1977. Most notably, the credit market tightening that had occurred by mid-year and the consequent slowing of deposit growth in thrift accounts is likely to reduce outlays for residential construction later this year and during 1979, whereas such spending provided significant impetus to real output growth last year.

Business fixed investment typically provides an increasing share of the stimulus to economic activity as an expansion proceeds. According to the Commerce Department survey of business anticipations, however, real outlays for plant and equipment are likely to increase less rapidly in 1978 than last year, providing another reason for the slowdown. Moreover, a deceleration in the pace of economic activity later this year means little additional increase in capacity utilization rates, thus making it less likely that businesses will step up their rate of capital expansion next year.

^{4/} The critical assumptions upon which the price projection is based are as follows: wholesale fuel prices rise 4.6 percent during 1978 and 7.2 percent during 1979; wholesale food prices rise 10.3 percent during 1978 and 6.4 percent during 1979; and little further depreciation of the dollar occurs.

Finally, consumer spending can be expected to provide little impetus to an acceleration in the growth of total demand. As described earlier in the chapter, a variety of factors will probably combine to slow the increase in constant dollar consumption spending both this year and next. Employment and income will probably increase less rapidly than they have to date in the expansion. Consumer installment debt has risen sharply relative to income. To the extent that the consumer attitude surveys are correct and the recent surge in retail sales has resulted in part from an inflation-induced, buy-in-advance psychology, the recent strength is being borrowed from later this year or from 1979. Finally, the reduced rate of housing turnover that is expected to result from tightening mortgage market conditions will reduce opportunities to liquidate equity in real estate, a practice that has helped sustain the advanced pace of consumer spending throughout the expansion.

Reasons for No Recession. A recession--frequently defined as two consecutive quarters of declining real GNP--can result from an unforeseen economic shock, such as an oil embargo. In the absence of such shocks and with the policy assumptions outlined above, a recession does not seem likely during the forecast period. The rationale for this assessment derives from a number of factors:

- o The tax cut included in the first concurrent resolution more than offsets the effects of rising payroll taxes and rising effective income tax rates and should help sustain consumer spending.
- o The tax cut should also stimulate additional business fixed investment; moreover, there are reports that businesses are under growing pressure to replace aging capital equipment.
- o The new regulation permitting banks and nonbank thrift institutions to pay market interest rates on deposits of \$10,000 or more may limit somewhat the effect of rising short-term interest rates on the availability of mortgage funds.
- o The recent depreciation of the dollar eventually may improve the performance of net exports.
- o Finally, there is little evidence of the imbalances between production and final demands that tend to characterize periods preceding recessions. As noted above, businesses have apparently held their inventories closely aligned with sales.

Outlook with Tight Monetary Policy

As emphasized throughout this report, the CBO projection assumes little further tightening of credit market conditions. No one knows precisely how much higher short-term rates can go before the economy is greatly weakened. Historical experience suggests not much further. In order to illustrate the critical importance of the monetary assumption in the projection, this section briefly outlines the probable consequences of a policy in which the Federal Reserve sharply raises short-term interest rates further. The three-month Treasury bill rate was assumed to rise to the neighborhood of its previous quarterly peak value of 8.5 percent in either late 1978 or early 1979, and then fall gradually over the remainder of the forecast period as the economy weakened. The results are shown in Table 7. 5/

Real growth would weaken in 1978 and output would probably decline during 1979, resulting in the seventh recession of the postwar period, with unemployment likely to rise above 7 percent. Although inflation would be unaffected in 1978, it would be reduced by about half a percentage point in 1979, with further reductions in later years as well.

To achieve this reduction in inflation, the tight money policy would reduce employment by over 2 million jobs by the end of 1979. This projected recession, like its predecessors, would reduce business profits and investment in plant and equipment and postpone still further advances in labor productivity and improvements in employment opportunities for the most disadvantaged. The next chapter will analyze the sources of the inflation problem in the U.S. economy and discuss in further detail the implications of reducing inflation by reductions in aggregate demand.

5/ Although there is considerable uncertainty concerning the relationship between money growth and interest rates, the above illustration assumes growth in M2 at or below the mid-point of the Federal Reserve target range. Because of the institutional changes described earlier, the associated growth of M1 cannot be estimated.

TABLE 7. ECONOMIC PROJECTIONS BASED ON TIGHTER MONEY: RATES OF CHANGE IN PERCENTS

Economic Variable	1977:4 to 1978:4	1978:4 to 1979:4
GNP (billions of current dollars)	9.4 to 11.5	4.3 to 6.9
Real GNP (billions of 1972 dollars)	2.8 to 3.8	-1.2 to 0.3
General Price Index (GNP Deflator, 1972=100)	6.4 to 7.4	5.6 to 6.6
Consumer Price Index (1967=100)	6.8 to 7.8	5.7 to 6.7
	<u>Level, End of Period</u>	
Unemployment Rate (percent)	5.8 to 6.4	6.9 to 7.7

CHAPTER III. INFLATION: ITS PERSISTENCE AND RECENT ACCELERATION

THE RECORD

At the heart of the current economic policy dilemma is the high rate of inflation. While the public debate on this issue has intensified recently, the fundamental problem and the difficult choices it presents are not new. The price performance of the U.S. economy has deteriorated badly over the past decade. The average annual rate of consumer price increase since 1968 has been 6.4 percent, more than three times as rapid as during the previous 20 years.

Many economists agree on the factors that initiated this period of rapid inflation. In the main, they point to continued government deficits and accelerated money growth during periods of widespread resource shortages--especially during the late 1960s--as well as sharply changing conditions in important individual markets, such as food and energy in the 1970s. There is less agreement, however, on why inflation seems to have become even more intractable recently. Over the three years since the trough of the 1974-75 recession--a period notably without resource shortages--consumer prices have increased at an annual rate of more than 6 percent.

Furthermore, the concern over inflation has been exacerbated recently by a sharp acceleration in the rate of price increase. The Consumer Price Index (CPI) rose at an annual rate of 10 percent during the first five months of 1978, well above the 6-3/4 percent rise in the year ending December 1977. This chapter will attempt to answer two questions:

1. What caused the recent acceleration of inflation?
2. What caused the persistence of high rates of inflation even during periods of economic slack?

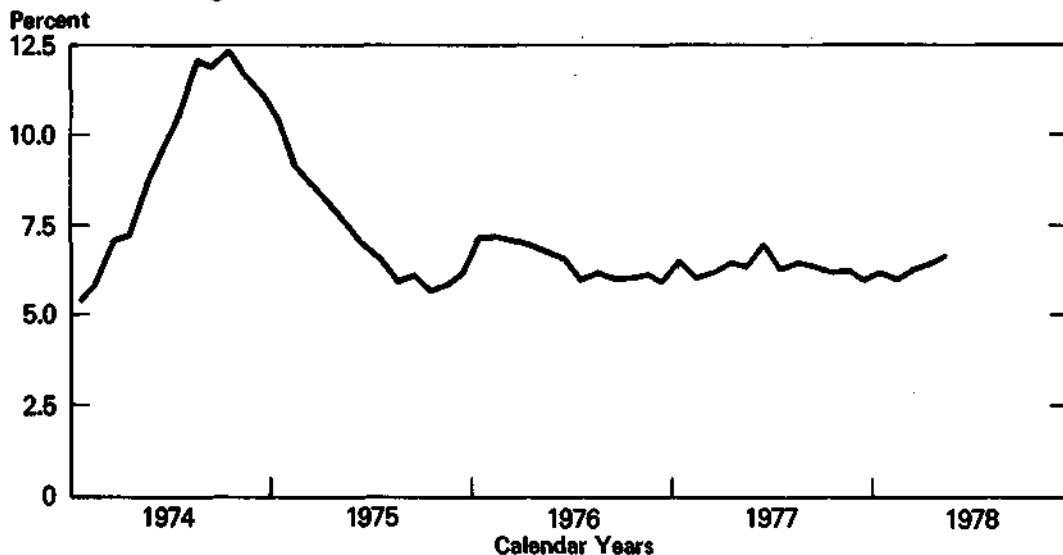
THE PERSISTENCE OF INFLATION IN A PERIOD OF ECONOMIC SLACK

Inflation has shown little tendency to decelerate during the past three years. Figure 6 presents the six-month rate of change

of a "stripped" CPI--one that eliminates some of the components, such as food and energy, that are more responsive to conditions of supply than to demand. According to this measure, prices have continued to rise at a 6 to 6.5 percent annual rate over the past three years. With the exception of the 1973-1974 period, this is the most rapid pace of inflation in 25 years, and it occurred despite prolonged periods of exceptionally high unemployment and low capacity utilization. This combination of economic conditions has been called "stagflation."

Figure 6.

**Rate of Change in Stripped Consumer Price Index:^a
Percent Change from 6 Months Earlier, Annual Rate**



SOURCE: U.S. Department of Labor, Bureau of Labor Statistics; calculated and seasonally adjusted by CBO.

^aExcluding food, energy, used cars, and mortgage interest.

In general, there are three explanations for such persistence of inflation:

- o First, the on-going price advance results principally from various interest groups using their economic and political power to maintain their traditional rates of real income growth.
- o Second, it results largely from inappropriate fiscal and monetary policies.
- o Third, the continued momentum of inflation during periods of high unemployment is rooted in self-fulfilling expectations--held by workers, business and consumers--about future high rates of price increase.

Attempts To Maintain Real Income Growth

When prices are rising rapidly, take-home pay buys less, but households find it difficult to lower their living standards. They have assumed obligations and hold expectations about the future; usually both are based on the anticipation of continued real income advance. It has become especially difficult for Americans to maintain their customary income growth since the share of total national income going to oil-producing countries increased.

In this environment of rapid inflation, households can attempt to maintain their traditional standards of living in a variety of ways:

- o Reducing household assets (although the assets of many households are neither sizable nor liquid);
- o Increasing household borrowing (reflected recently in the movement of the ratio of consumer debt to personal income to a relatively high level); and
- o Increasing household labor-force participation (reflected in the continued rapid influx of married women into the labor force).

Similarly, many groups in the economy try to maintain customary real income growth in a number of ways, including:

- o Efforts to reduce taxes (today manifested in a growing taxpayers' revolt, marked most recently by the passage of sharp reductions in property taxes in California); and
- o Linking income to the movement in consumer prices, perhaps with a customary annual improvement of real income factored in. Such linking, either implicit or explicit, is called indexing.

This section examines the role that the explicit or implicit indexing of wages and other incomes to the CPI has played in the persistence of inflation during the recent period of economic slack.

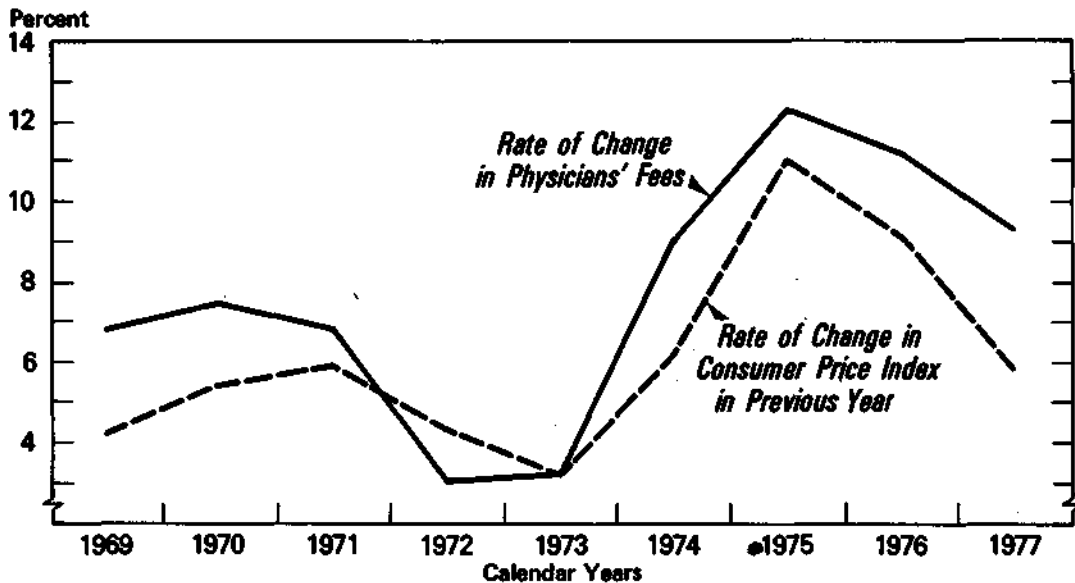
If labor markets are tight, then competitive pressure by firms to fill job vacancies will bid up worker compensation; in

such circumstances, wages and prices increase together. If labor markets are slack, however, firms are under no competitive pressure to raise wages. Yet, even during periods of widespread unemployment, the wages paid to a large number of workers can continue to rise rapidly because they are linked closely to past price behavior.

Such linking can occur through either contractual or less formal processes. Informal indexing has been the consequence of a variety of factors, including the threat of union organization and the general attempt by firms to maintain the morale and productivity of their workers. Under such circumstances, wage policy has been affected by considerations of workers' perceptions of equity--a concept heavily influenced by the rate of real wage gains that employees have come to expect as a result of past experience.

In addition, professional organizations have used their market and political power to help maintain traditional growth in members' real income. For example, as can be seen in Figure 7, except for the period of mandated medical cost controls in the early 1970s, the movement in physicians' fees corresponds quite closely to the previous year's change in consumer prices.

Figure 7.
Rate of Change in Physician's Fees and Lagged Rate of Change
in Consumer Price Index



SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Another important vehicle of largely implicit indexing has been the wide variety of government actions taken to alleviate the impact of inflation on living standards. These actions have attempted either to increase incomes directly or to reduce competition in order to provide more room for groups to increase incomes on their own, including:

- o Increased minimum wage;
- o Increased social security benefits (through a cost-of-living escalator), which helped lead to higher payroll taxes;
- o Increased farm price supports;
- o The steel price referencing plan; and
- o Various orderly marketing agreements limiting imports for products such as television sets. 1/

The effects of some of these programs are difficult to quantify, but certainly the pressure on prices is upward. Overall, most analysts agree that government cost-raising actions have played an important role in sustaining the inflationary momentum of the past three years.

1/ Other government cost-raising activities contributed to the persistence of measured inflation over the past three years but were motivated by the desire to correct some perceived external diseconomy; efforts here include environmental standards and worker health and safety regulations. It has been estimated that these regulations have been adding three-quarters of a percentage point to the annual rate of inflation. See Thomas D. Hopkins, "Current Inflationary Conditions and Regulatory Measures of the Council on Wage and Price Stability," Papers and Proceedings of a Symposium on Inflation (University of Tennessee, March 1978).

Contractual indexing of wages to consumer prices is usually accomplished by cost-of-living (COL) escalators included in union-management agreements. About 60 percent of all workers covered by major collective bargaining contracts receive periodic wage adjustments based on the increase in consumer prices. Such escalator clauses, along with annual improvement increases and first-year catch-up wage adjustments, are designed to maintain traditional real wage growth for union members. Furthermore, for many unions, the desire and ability to maintain customary real growth appears relatively insensitive to fluctuations in total demand. 2/

The importance of wage catch-up to past inflation was demonstrated clearly in the 1976 bargaining round, the results of which are summarized in Table 8. There was great heterogeneity in cost-of-living protection by major unions going into the negotiations in that year. The Rubber Workers had no COL escalator in their existing contract, while the Teamsters and Electrical Workers had capped escalators. 3/ The Auto Workers, on the other hand, had the benefit of an uncapped COL escalator during the previous three years. The pattern of the first-year settlements reflected the differing needs of each union to restore real wages eroded by the rapid 1973-1976 inflation. Since the total wage and benefit adjustments scheduled in each contract were well above productivity gains, these settlements placed significant upward pressure on prices; each has contributed and will continue to contribute to the momentum of inflation. Furthermore, these large settlements were made despite weak labor demand in the industries; indeed, demand for labor was the strongest in the auto industry, which had the smallest first-year wage adjustment, and weakest in the tire industry, which had the largest catch-up increase.

2/ The relative insensitivity of current dollar wage change in high-wage industries to variations in labor-market slack has been demonstrated generally by George Perry, "Slowing the Wage-Price Spiral: The Macroeconomic View" (The Brookings Institution, April 1978).

3/ Capped cost-of-living escalators set a maximum limit on the annual rate of wage increases; for both the Teamsters and the Electrical Workers, these contractual limitations in combination with the rapid inflation caused real wages in the mid-1970s to lag behind their long-term trend growth.

TABLE 8: ESTIMATED WAGE ADJUSTMENTS DURING THE 1976 BARGAINING YEAR

	Previous Cost- of-Living Adjust- ment (COLA) Pro- tection	First Year Increase (percent)	Total Increase Over 3-year Life of Contract a/ (percent)	Employment Shortfall b/ (percent)
Trucking	Capped COLA	9.1	31.9	-10.7
Electrical Equipment	Capped COLA	13.1	32.7	-13.7
Tires	No COLA	17.1	39.5	-18.3
Automobiles	Uncapped COLA	6.1	27.2	-0.4

a/ Assuming steady 6 percent inflation.

b/ The percent difference between production worker employment at the time of the contract reopening and the prerecession employment peak in 1974; the Standard Industrial Classification (SIC) code used to obtain the employment data was chosen to correspond as closely as possible to the actual bargaining unit involved in the negotiations.

As the 1976 example illustrates, formal and informal mechanisms of income catch-up to past price increases have contributed significantly to the momentum of inflation during the recent period of economic slack. High inflation in one period has led to compensating income adjustments in later periods for a substantial share of the population; these income increases--to the extent they are business costs--are subsequently reflected in further price increases, and the spiral continues.

Fiscal and Monetary Policies

It has been argued that smaller budget deficits and slower money growth would have retarded the rise in prices over the past three years. While this statement is true, the cost of such measures must also be considered, and previous experience indicates that this cost in terms of lost production and employment would have been high.

According to conventional economic analysis, restrictive fiscal and monetary policies slow inflation largely by increasing slack in the economy. The less responsive wages and prices are to unemployment and idle plant and equipment, the greater are the lost production and employment needed to reduce inflation. The available data since 1975 show that the recent price advance was relatively insensitive to widespread economic slack (see Table 9). The rate of increase of consumer prices--stripped of some of its components that are more responsive to supply conditions than demand--decelerated only slowly despite substantial excess productive capacity, and labor compensation growth remained quite high. Once inflation gets started, it tends to persist, largely because of the formal and informal indexing of wages and other income claims to past price increases. As a result, the amount of economic slack necessary to reduce inflation quickly is very large.

Simulations with the large macroeconomic models confirm this conclusion. One recent review of the estimates provided by six different models found that it takes an extra one percentage point of joblessness for one year to reduce inflation on average by 0.3 percentage point. If sustained for three years, this degree of additional labor market slack would lower the rate of price rise by

TABLE 9. INFLATION AND ECONOMIC SLACK, 1975-1977

	Annual Average 1949-1974	1975	1976	1977
Inflation (Annual rates of increase, end of year from end of previous year)				
Stripped CPI (percent) <u>a/</u>	2.9	6.8	6.3	6.3
Compensation per hour (percent) <u>b/</u>	5.5	8.1	9.2	8.7
Economic Slack				
Unemployment rate (percent)	4.8	8.5	7.7	7.0
Manufacturing capacity utilization rate (percent)	84	74	80	82

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics;
Board of Governors, Federal Reserve System.

a/ Excluding food, energy, used cars, and mortgage interest.

b/ Private nonfarm business.

between 0.6 and 1.8 percentage points. 4/ While the estimates vary somewhat, the message of these models is clear: restrictive economic policy can slow an inflationary momentum, but the cost in terms of lost output and employment is high.

4/ Arthur M. Okun, "Efficient Disinflationary Policies," a paper presented at the meetings of the American Economic Association, December 28, 1977.

Expectations

Some economists have argued that, contrary to the econometric model simulations just mentioned, more restrictive fiscal and monetary policies in the circumstances of the past three years would have resulted in only moderate additional joblessness and that the downturn would have been relatively short-lived. This argument is derived from the view that the current momentum of inflation is a consequence of generalized expectations of continued rapid price change. It is asserted that formal or implicit contracts governing prices and wages increasingly have come to be formulated on the basis of the parties' expectations of future inflation. If these expectations are maintained, then they become a self-fulfilling prophecy.

According to this view, an essential goal of fiscal and monetary policies is to change expectations of inflation. Proponents argue that the most effective way to change such expectations is to convince the parties to wage-price decisions that the growth of demand will be insufficient to accommodate their price anticipations. Once convinced that future inflation will slow, the private sector will revise downward its planned wage and price adjustments, slowing inflation with little impact on real activity.

The expectations approach challenges the orthodox view that a macroeconomic policy designed to combat inflation will necessitate a period of extensive resource underutilization. The conditions under which an expectations-based policy would work should be examined closely. There are at least two necessary conditions for the success of this approach:

- o A stringent and credible macroeconomic policy designed to constrain the growth in current dollar demand must be announced in advance.
- o Adjustments in current income claims must be based on expectations of future--not on past--inflation.

The second condition is particularly significant. There is no doubt that expectations of future inflation significantly affect prices in financial markets, especially longer-term interest rates. Anticipations of higher future price increases reduce the willingness of investors to make their savings available at accustomed rates of return, and the capital costs of business

increase. Financial costs, however, are a relatively small share of the total costs of production. And the expectations-based rationale is less convincing once attention is turned to the determination of labor compensation, which accounts for more than two-thirds of total business costs.

As has been seen, the nature of the wage adjustment process--characterized by formal and informal cost-of-living escalators and first-year catch-ups--causes wage movements to reflect past inflation. In addition, these adjustments were shown to be relatively insensitive to fluctuations in total demand. To the extent that wage gains are indeed a catch-up to past real income loss and are not responsive to rising economic slack, then the imposition of restrictive fiscal and monetary policies would not be quickly reflected in significantly reduced inflation. Rather, they would result in an extended period of high unemployment and lost production.

THE RECENT ACCELERATION OF INFLATION

Why has inflation accelerated since the beginning of the year? Some point to the occurrence of price shocks during this period, while others contend that the surge in prices resulted from widespread shortages of labor and capital.

Price Shocks

Examination of the data indicates that the acceleration in inflation at the beginning of this year resulted primarily from the simultaneous occurrence of three events:

- o Food prices accelerated rapidly, up at a 22 percent annual rate during the first five months of the year after rising at only a 2.4 percent annual rate during the second half of 1977.
- o The value of the dollar against other major currencies fell sharply, down about 6 percent on a trade-weighted basis since last autumn.

- o Sharply increased payroll taxes used to fund social security programs and a 15 percent hike in the minimum wage went into effect on January 1, 1978.

Indeed, these three factors are estimated to have accounted for about 90 percent of the acceleration in prices during the first half of this year.

Food Prices. The sharp upward movement in food prices was widespread. In part, the acceleration was the result of production and marketing difficulties caused by the harsh winter. A similar movement occurred last year, and it is expected that some of the recent increases will be reversed later in the year, as they were in 1977.

Some of the 1978 acceleration in food prices, however, was the result of reduced cattle supplies. Although the exact timing was uncertain, an increase in beef prices had been widely expected. As a result of relatively low cattle prices in recent years, herds have been reduced sharply. Efforts to rebuild cattle stocks require the withholding of heifers from slaughter, and such rebuilding efforts appear to have begun recently. Largely as a result of this reduced supply, meat prices have increased at a 43 percent annual rate since the turn of the year--accounting for about a third of the overall acceleration of consumer prices (see Table 10). Typically, beef prices drop somewhat after a rapid run-up, and a decline may occur during the second half of 1978. Since the rebuilding phase of the cattle cycle takes about five years, however, this reduction will probably be temporary as beef prices accelerate again next year. Overall, food price rises are responsible for about half the acceleration of the CPI from the second half of last year.

Depreciation of the Dollar. Currency depreciation directly affects domestic prices in three ways. First, import prices rise; since the dollar fell most dramatically relative to the Japanese yen (down 15 percent in the 6 months since October) and to the German mark (down 11.5 percent over the same period), (see Table 11) imports from these two countries have shown a significant increase in price.

Second, prices of domestically produced products that are competitive with imports from Japan and Germany--such as steel and autos--also have increased as competitive pressures eased. Price

TABLE 10. RECENT FOOD PRICE MOVEMENTS

	Relative Importance	Percent Change, Seasonally Adjusted Annual Rate		
		Dec. 1976 to June 1977	June 1977 to Dec. 1977	Dec. 1977 to May 1978
Total Food at Home	100.0	14.0	2.4	22.1
Meats, poultry, fish and eggs	32.2	6.8	1.5	43.1
Fruits and vegetables	14.4	8.4	10.9	20.5
Cereals and bakery products	12.5	5.0	6.0	11.0

SOURCE: U. S. Department of Labor, Bureau of Labor Statistics.

competition in the subcompact auto market--where imports from Japan and Germany are particularly strong--was lessened significantly when foreign auto prices rose 10 percent or more as a result of the dollar depreciation. For example, some domestic subcompacts increased in price 8 percent from the start of the new model year last fall to mid-1978--well above the price increases recorded for larger models. The effect of depreciation is equally evident in recent steel price behavior. The steel industry had been losing an increasing share of its domestic market to imports, especially from Japan. Following the dollar depreciation and the announcement of the new reference price system, finished steel prices at wholesale rose at a 7.5 percent annual rate between January and June of 1978.

TABLE 11. CHANGE IN THE VALUE OF THE DOLLAR AGAINST OTHER CURRENCIES

	<u>Percent Change from 6 Months Earlier a/</u>		
	<u>1977</u>		<u>1978</u>
	April	October	April
Change Against:			
Trade-weighted Average, Major Currencies	-0.8	-1.9	-6.0
Japanese Yen	-5.8	-8.0	-14.8
German Mark	-2.3	-4.2	-11.5

a/ Not annual rate.

The third way that a currency depreciation can raise domestic prices is through rising export sales increasing the level of aggregate demand. Depending on the degree of capacity utilization in the domestic economy, such an increase in demand could lead to higher prices.

Based on past behavior of the economy, it is estimated that 6 percent depreciation eventually may add 1-1/4 percentage points to the rate of growth of the CPI as a result of these three factors. If half the recent currency depreciation was reflected in consumer prices by midyear, then about one-quarter of the recent acceleration in inflation resulted from rising import prices.

Government Actions. Increases in payroll taxes and the minimum wage also increased production costs significantly at the beginning of 1978. It is estimated that a full pass-through of these cost increases would increase the rate of change in prices by one-half to three-quarters of a percentage point. (See Chapter IV for detailed estimates of the economic effects of the payroll tax changes.) Even though the full effect of this rise will not occur until later in 1978, it is probable that these government

actions caused nearly one-fifth of the acceleration in prices since the beginning of the year. Other government cost-raising programs also may have contributed to the recent acceleration of inflation, but they are much more difficult to quantify. ^{5/}

Taken together, it is estimated that higher food prices, the dollar depreciation, and cost-raising programs accounted for about 90 percent of the acceleration of inflation from the last half of 1977 to the first half of this year.

Resource Shortages

While most analysts agree that the recent acceleration in inflation is rooted in large part in food prices, currency depreciation, and government cost-raising actions, it is possible that the increase is also the result of shortages in available labor and capital.

Labor Shortages. It may seem odd to be analyzing the possibility of widespread labor shortages when the jobless rate has just recently fallen below 6 percent and is still well above the postwar average unemployment rate. It may be argued, however, that recorded joblessness today presents an overly optimistic picture of the available labor supply relative to past experience. This argument has two parts:

- o As a result of the coming of age of the postwar baby boom and rising participation rates, a growing share of the labor force is composed of new entrants and re-entrants to the work force; since these workers typically experience higher joblessness as they search--often

^{5/} For a review of existing government cost-raising programs, See Robert W. Crandall, "Federal Government Initiatives to Reduce the Price Level" (The Brookings Institution, April 1978).

through trial-and-error--for satisfactory jobs, the overall recorded jobless rate consistent with a given degree of true labor-market slack may increase. It is estimated that this demographic change may have added about 1 percentage point to the total unemployment rate over the past 20 years.

- o As a result of liberalized public and private income support programs for the jobless, it may be rational for some persons to choose to be unemployed even when there are suitable job openings; thus, the recorded jobless rate may include a greater share of voluntary unemployed who are not truly available for work. 6/

In view of the uncertainty about the overall unemployment rate as a guide to labor-market tightness, some more specific alternative measures of current availability of workers may be useful (see Table 12). These supplementary indicators--unemployment rates for men aged 35 to 54, married men (spouse present),

6/ Conversely, a significant way in which the recorded jobless rate may underrepresent the true degree of labor-market slack is by exclusion of persons who would take jobs but, because they believe none are available, have not actually looked for work in the past month. The Bureau of Labor Statistics (BLS) estimates that 842,000 persons--approaching one percent of the civilian labor force--were not in the labor force in the second quarter of 1978 because they thought they could not get a job.

women who head families, craft workers and managers---typically fall sharply in periods of general labor scarcity, yet they should be less sensitive to the factors that distort the overall jobless rate. 7/ As can be seen, the available evidence does not show any widespread shortages, at least when measured against previous postwar experience. Recent unemployment rates for these selected groups are still well above those in periods of labor market tightness, such as 1966, 1969 and 1973.

Although the recent acceleration of inflation resulted from price shocks rather than from a scarcity of available workers, this does not mean that widespread labor shortages will not occur in the next year and a half. Indeed as can be seen in Table 12, jobless rates at midyear were roughly similar to the levels recorded in 1972; by early 1973, continued rapid economic growth led to a general scarcity of labor and excess demand inflation. As in 1972, the economy is now entering a zone of caution for policymakers, where appropriate action depends on the assessment of the future course of nonfederal demands. If these demands slow as projected, and unemployment remains near its midyear level, then there is little likelihood of upward pressure on prices from labor shortages through 1979. However, if economic growth remains strong and the jobless rate continues to drop significantly, general worker scarcities could occur within the forecast period, and wage and price inflation could accelerate.

7/ Martin Feldstein has shown that liberalized unemployment compensation should have the greatest distorting effect on the job-seeking activities of household members other than the principal breadwinner; the alternative jobless rates given in Table 3 measure labor-market slack largely among principal household earners and, therefore, should be less influenced by the demographic or income-support changes. See Martin Feldstein, "Unemployment Compensation: Adverse Incentives and Distributional Anomalies," National Tax Journal (June 1974).

TABLE 12. MEASURES OF LABOR-MARKET SLACK--UNEMPLOYMENT RATES FOR SELECTED GROUPS (IN PERCENTS)

	1964	1966	1969	1972	1973	June 1978
Total	5.2	3.8	3.5	5.6	4.9	5.7
Men, Aged 35-54	3.0	2.0	1.5	2.7	2.1	2.7
Married Men, Wife Present	2.8	1.9	1.5	2.8	2.3	2.7
Women Who Head Families	NA	NA	4.4	7.2	7.0	8.8
Managers, Administrators	1.4	1.0	0.9	1.8	1.4	1.8
Craft and Kindred Workers	4.2	2.8	2.0	4.3	3.7	4.2

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Plant and Equipment Shortages. Available data on current utilization of plant and equipment show a picture similar to that of the labor market. Manufacturing operating rates have increased significantly from their exceptional recession lows, but there has been little further improvement over the past year, and utilization remains at its postwar average. As can be seen in Table 13, the picture is about the same in the critical primary processing sector.

Other evidence also indicates that there were no widespread shortages of plant and equipment during the recent period of accelerating prices (see Table 13). Vendor performance (change in the time elapsed between orders and delivery of industrial materials) remains well below previous periods of extensive shortages

such as 1966 and 1973. In addition, manufacturing overtime hours--a typical way to adjust for shortages in plant and equipment--were little changed in June 1978 from a year earlier, and there have been few reports of third shifts being started. Moreover, there has been to date little apparent rush by business to accelerate spending on expansions of heavy equipment, an area that has lagged badly since the recession. It has been argued that this lagging rate of investment has resulted in part from a persistent overhang of unused industrial capacity, both in the United States and abroad.

TABLE 13: MEASURES OF CAPACITY UTILIZATION

	Postwar Average	1964	1966	1969	1972	1973	June 1978
Capacity Utilization (percent)							
Manufacturing	0.83	0.86	0.91	0.86	0.83	0.88	0.84
Primary Process- ing	0.85	0.88	0.91	0.89	0.88	0.92	0.86
Vendor Performance <u>a/</u>	0.51	0.63	0.73	0.65	0.63	0.88	0.66
Manufacturing Overtime Hours	NA	3.1	3.9	3.6	3.4	3.8	3.5

SOURCES: Federal Reserve; U. S. Department of Commerce, Bureau of Economic Analysis; U. S. Department of Labor, Bureau of Labor Statistics.

a/ Percent of purchasing agents reporting slower deliveries of materials.

Looking ahead, however, it is possible that more general shortages of plant and equipment may be encountered during the next year and a half. As with labor availability, the prospect for manufacturing capacity scarcities depends on the future rate of growth in demand. If growth is unexpectedly strong through 1979, production bottlenecks would increase, placing additional upward pressure on prices.

SUMMARY

The available evidence indicates no widespread shortages of labor and capital during the first half of 1978. The acceleration of inflation resulted from other causes--particularly the rapid runup in food prices, the dollar depreciation, and the January increases in the payroll tax and the minimum wage. This acceleration, however, will contribute to the continuing momentum of inflation as wages and other incomes catch up to these higher prices later this year and in 1979. Moreover, if economic growth is stronger than expected, increased shortages of labor and capital could be encountered before the end of next year and result in a further acceleration of inflation.

In the last six months, since the CBO forecast was prepared for the first concurrent resolution, the outlook for inflation has significantly worsened and the likelihood of slower real growth in 1979 has increased. ^{1/} Policymakers must also contend with structural problems. In particular, unemployment rates are likely to remain extremely high for some labor force groups--such as black teenagers--and the outlook for business investment falls short of the amount needed to return productivity growth to its earlier higher rates.

What are the implications of this forecast for the second concurrent resolution? Unfortunately, there appears to be no single policy change that can solve all of the problems mentioned above, and solutions to one problem may make others worse. Macroeconomic policymakers may have to choose which battles to fight--inflation, unemployment, budget deficits, the size of the public sector, long-term growth, and so forth--since they are not likely to achieve all goals simultaneously.

The recent flare-up in inflation and the projected slowdown in economic growth make fiscal policy decisions especially difficult. The analysis presented in the previous chapter suggests that the most recent bulge in inflation is due primarily to supply-related factors, and not to generalized demand pressing against available resources. This situation creates a serious policy dilemma. Restrictive aggregate-demand policies can have little direct effect in retarding an inflation that stems from such supply shocks. In these circumstances, such policies can reduce the overall rate

^{1/} Congressional Budget Office, The Economic Outlook (February 1978). The current inflation forecast is one percentage point higher for 1979. Economic growth, with the fiscal stimulus of the first concurrent resolution, is now expected to be slightly less than projected in the earlier report. The risk of a serious credit squeeze is now much greater. But the recent drop in unemployment has lowered the unemployment rate that, with the projected growth, now appears to be attainable.

of inflation only at the cost of substantially lower growth in output and higher unemployment. At the same time, the amount of slack in the economy has been reduced considerably, and the economy is entering a caution zone in which stimulative policies risk accelerating inflation.

RESTRICTIVE FISCAL POLICY OPTIONS

If the Congress believes that the fiscal policy of the first resolution provides too much stimulus at this stage of the expansion--particularly in light of the persistence of inflation--it can take steps to reduce the fiscal year 1979 deficit. A reduction in fiscal stimulus could be achieved by either higher taxes or lower spending. One way of achieving this goal would be to forego all or part of the planned tax cut.

No Tax Cut Option. The first concurrent resolution provided for a \$15 billion cut in taxes for fiscal year 1979 (effective January 1979 at a \$20 billion annual rate) as compared with revenues from current policies. ^{2/} According to CBO estimates, if the entire tax cut were dropped, real growth from the fourth quarter of 1978 to the fourth quarter of 1979 would be about 0.5 percentage point lower and the unemployment rate would be 0.2 percentage point higher than the baseline forecast. As shown in Table 14, the restrictive effect of the no tax cut policy option would be somewhat greater by the end of 1980. The price level, as measured by the Consumer Price Index, would be only around 0.2 percent lower by the end of 1980; however, inflation would be dampened more in the years that follow.

Reduced Spending Option. A restrictive economic effect could also be attained by cutting expenditures. Achieving a significant reduction in spending would, however, require difficult actions, such as foregoing the October pay raise for federal employees and sharply reducing the planned new spending initiatives for defense, agriculture, urban aid, veterans' benefits, and other programs that have not yet been enacted. Alternatively, to achieve a spending reduction and still provide room for some new spending initiatives,

^{2/} Current policy is assumed to include an extension of the temporary tax cuts enacted in 1977.

TABLE 14. ESTIMATED ECONOMIC EFFECTS OF THE NO TAX CUT OPTION

Economic Variable	<u>1979:4</u>	<u>1980:4</u>
GNP (billions of current dollars)	-17	-31
GNP (billions of 1972 dollars)	-10	-16
Unemployment Rate (percent)	+0.2	+0.4
Employment (millions)	-0.3	-0.4
Consumer Price Index (percent change from base)	-0.02	-0.2

savings could be sought in existing programs. Assuming that the Congress could cut spending by \$10 to \$15 billion beyond the estimated \$4 billion shortfall, the effect of this cut on economic activity would be roughly similar to the effect of eliminating the tax cut (described above), depending on the composition of the reductions.

The Risk of Restrictive Policies. If the Congress were to forego the tax cut or make comparable cuts in spending, fiscal policy would be more restrictive in fiscal year 1979 than in 1978. To the extent that the economy is approaching a general condition of shortages of labor or manufacturing capacity, such a reduction in fiscal stimulus could diminish the risk of generating inflation. However, real growth appears to be slowing, and there is a substantial danger that monetary and fiscal policies will become simultaneously restrictive--a shift that in the past has generally been followed by recession.

AN EXPANSIVE FISCAL POLICY OPTION

In contrast to the restrictive measures described above, the Congress has before it a proposal for reducing taxes sharply without altering expenditures. This proposal calls for a one-third reduction in personal income taxes and a smaller cut in corporate

income taxes, phased in over a three-year period. ^{3/} In the first calendar year, this tax cut would be about 50 percent larger than the tax reduction included in the first concurrent resolution. If the CBO forecast of reduced growth and continued slack is correct, then the first-year tax reduction probably would not significantly worsen the outlook for inflation. But the commitment to very large subsequent tax cuts would clearly involve a substantial risk of such an outcome in the second or third years. Conventional economic analysis indicates that, as a result of such a policy, the budget deficit would rise sharply. With the economy likely to encounter a general scarcity of labor and other production bottlenecks during the second or third year, a large stimulus of this kind would be highly inflationary.

Some proponents of this policy option, however, argue that the conventional view is incorrect. They contend that large tax cuts greatly increase incentives to work, save, and invest, and they argue that the resulting growth in production and income would be so rapid that the tax cuts would "pay for themselves" in the first or second year, resulting in no increase in the deficit. According to this view, the tax cuts would have such large effects on aggregate supply that they would not be inflationary.

CBO has not found any empirical support for the view that supply-side effects from tax cuts such as those proposed in H.R. 8333 are so large and so quick. The evidence available to us supports the mainstream view that individual and corporate income tax rate reductions, while stimulative, are not self-financing. Moreover, this evidence indicates that the stimulative effects of most types of tax cuts occur primarily through increased aggregate demand and that such large tax cuts therefore carry a great potential for accelerating inflation, unless there is a great deal of slack present in the economy.

THE COMPOSITION OF FISCAL POLICY AND THE MONETARY-FISCAL POLICY MIX

Although the Congress cannot expect to achieve all of its economic goals quickly, some combinations of policies that would help improve the performance of the economy are available. For

^{3/} H.R. 8333, the Kemp-Roth Tax Reduction Act.

example, it may be possible to improve the tradeoff between inflation and unemployment by changing the composition of the budget or by introducing structural changes. This section looks at possible changes in the composition of macroeconomic policies; the final section looks at some structural ways of improving the performance of the economy.

The Composition of Fiscal Policy

Cutting Both Revenues and Expenditures. Cuts in both spending and taxes have been proposed as a way to reduce the size of the federal sector. The precise effects of this type of policy would depend on the size of the cuts, the particular taxes and expenditures that were cut, and the timing of those cuts. CBO analyzed an illustrative \$10 billion, annual rate, cut in spending and taxes. The tax cut (\$7.5 billion for the fiscal year 1979) was the same composition and timing as the tax cut included in the first concurrent resolution. A \$10 billion across-the-board cut in government spending (except for interest payments), was assumed to become effective the fourth quarter of 1978. It is estimated that such a program is, on balance, contractionary, partly because of the earlier effective date of the expenditure cut: in the fourth quarter of 1979, real GNP would be lower by roughly \$4 billion (in 1972 dollars), and the unemployment rate would be slightly higher (by 0.1 percentage point). If the cut in spending were solely in purchases of goods and services and were combined with the tax cut, CBO's simulations suggest that the resulting reduction in output would be approximately twice as large as that resulting from the across-the-board cut in spending and the tax cut, because changes in purchases generally have more powerful effects on economic activity than do changes in transfer payments. ^{4/} Of course, if income taxes were cut more than spending, the size of the federal sector could be reduced with no aggregate effect, or even an overall stimulative effect, on economic activity.

Reducing Payroll Taxes Instead of Personal Income Taxes. It has been recommended that the Congress slow inflation by cutting payroll taxes instead of personal income taxes. Considerations

^{4/} See Congressional Budget Office, Understanding Fiscal Policy (April 1978).

other than macroeconomic effects, such as keeping the financing of the social security system separate from the rest of the federal budget, enter into such decisions; but from the economic perspective alone, there appear to be significant advantages to this proposal.

The short-run impact of a cut in the employee share of a payroll tax appears to be quite similar to a cut of similar size in the personal income tax. But while a reduction in the employer share appears to have similar real effects, its impact on the price level is more favorable than a cut of similar size in personal income taxes. According to CBO analysis, a reduction in the employer share of payroll tax will, on balance, lower prices, while a cut in personal taxes leads to an increase in the price level. The size of the effect on prices is, however, uncertain. There is disagreement over the extent to which employers may shift the burden of the payroll tax to workers by paying lower wages than would otherwise be the case. It is probable that the effect of lower taxes shows up partly in lower prices and partly in higher wages.

CBO recently compared the economic effects of \$10 billion reductions in social security taxes and personal income taxes; the results are summarized in Table 15. Bearing in mind that the estimates are subject to a good deal of uncertainty, the CBO analysis suggests that such a payroll tax cut would decrease the CPI by about 0.3 percent by the end of the first year, whereas the personal income tax cut would increase the price level.

Investment Incentives. As discussed in CBO's report, The Economic Outlook, there are several fiscal tools available for stimulating business investment. Probably, the most effective tools (per dollar of budget cost) are increasing the investment tax credit and accelerated depreciation. These instruments are specifically focused on the investment decision. Two other instruments--reductions in the corporate income tax and reductions in capital gains taxes--are sometimes mentioned as ways of stimulating investment, but substantially less evidence relating to their effectiveness is available.

TABLE 15. APPROXIMATE EFFECTS OF TWO ILLUSTRATIVE \$10 BILLION
TAX REDUCTIONS a/

Economic Variable	Personal Income Tax	Payroll Tax
After 4 Quarters		
GNP (billions, 1972 dollars)	7	7 <u>b/</u>
Unemployment rate (percent)	-0.2	-0.2 <u>b/</u>
Employment (thousands)	200	200 <u>b/</u>
General Price Level, (percent change)	<u>c/</u>	-0.2
After 8 Quarters		
GNP (billions, 1972 dollars)	10	10 <u>b/</u>
Unemployment rate (percent)	-0.3	-0.3 <u>b/</u>
Employment (thousands)	400	400 <u>b/</u>
General Price Level, (percent change)	+0.1	-0.3

a/ Calculations assume the general economic conditions of 1978.

b/ Data shown for GNP, unemployment rate, and employment are the estimated effects of a personal income tax cut. It is assumed that a payroll tax cut of the same size would have approximately the same GNP and employment effects.

c/ Less than +0.05 percent.

The Monetary-Fiscal Policy Mix

Improved coordination of fiscal and monetary policies could be an important step in helping the Congress achieve its short-run goals for employment and prices. In addition, some hold that a different policy mix might improve the long-run performance of the economy.

Coordination and Short-Run Goals. Past experience suggests that some instances of poor performance by the economy have resulted from excessive monetary and fiscal policy shifts in the same direction. Perhaps fiscal and monetary policymakers each assumed that the other would not take appropriate action in response to current trends, and together they overreacted. Such an overreaction cannot be discounted at the present time. If fiscal and monetary policies are both used to reduce inflationary pressures, the chances of a recession are great.

Aside from the possibility of an overreaction, some argue that the short-run economic outlook would be improved by a coordinated policy involving a more restrictive budget and a more expansive monetary policy. The case for this change seems to rest on the assumption that with such a policy it would be possible to avoid higher short-term interest rates and the resulting movement of funds from thrift accounts into higher yielding short-term market instruments, which would lead to a serious downturn in housing.

The Monetary-Fiscal Mix and Long-Run Goals. It also has been argued that the long-run performance of the economy would be improved by a tighter fiscal policy and an easier monetary policy. That mix might have a number of desirable outcomes, including:

- o Reduction of federal deficits and, perhaps, decreasing the size of the federal sector as well; and
- o Encouraging investment spending, with the resulting growth in industrial capacity reducing inflationary pressures.

A recent economic study by Data Resources, Inc., for example, indicates that a reduction in government spending and a concomitant

easing of monetary policies reduces short-term interest rates, substantially stimulates housing, and provides some small impetus to business fixed investment. 5/

Some of the advantages of a fiscal-monetary policy shift, however, could be achieved through fiscal policy instruments alone. As discussed above, if the nation wants to stimulate business investment, it could rely more heavily on such fiscal tools as the investment tax credit or accelerated depreciation.

Implementing Coordination. There are several difficulties in instituting a shift in the monetary-fiscal mix for short-term objectives. Economic knowledge of the size and timing of monetary and fiscal policy effects is limited. More important, adequate arrangements for choosing specific economic goals and implementing a coordinated policy do not now exist.

Although attempts at closer coordination of fiscal and monetary policies are not without their risks, the benefits in terms of economic stability and growth could be substantial. Hence, this may be an appropriate time to examine mechanisms for improving coordination of monetary and fiscal policies, such as requiring the Federal Reserve to:

- o Clearly specify its money and credit targets for the ongoing and upcoming fiscal year, before enactment of the budget resolutions;
- o Reveal its estimates of the level of unemployment, production, and prices for the end of the fiscal years; and
- o Explain periodic revisions of its objectives and plans.

5/ Allen Sinai, "The Conduct of Monetary Policy: Performance and Prescription," DRI Review, July 1977. In one of these simulations, the growth in federal expenditures was held to 1 percent per year and money growth was increased so that the path of real output for the economy remained approximately unchanged from that with higher federal expenditures and slower money growth.

OTHER (NON-AGGREGATE) APPROACHES

The dilemma facing policymakers could also be made less acute by a variety of structural changes that directly reduce inflation and/or unemployment. While not cure-alls, such measures could be helpful supplements to traditional fiscal and monetary policies.

Policies to Reduce Inflation

In general, the Congress can use three types of measures to reduce inflation directly:

- o Modify government actions that raise costs and prices;
- o Intervene directly in the wage-price determination process with some form of incomes policy; and
- o Promote measures to increase the supply of goods and services.

Government Actions. A number of government actions have the effect of raising costs and prices. Included are the various limitations on the import of foreign goods, the minimum wage, agriculture price supports, the regulation of transportation, federal excise taxes, state sales taxes, and payroll taxes. It has been estimated that the direct effect of a modification of these programs would be a one-time decline in the price level by more than 5 percent. ^{6/} As noted in Chapter III, environmental standards and worker health and safety regulations also have added significantly to the current momentum of inflation.

^{6/} The impact was estimated using the gross private domestic deflator. See Robert W. Crandall, "Federal Government Initiatives to Reduce the Price Level" (The Brookings Institution, April 1978).

Of course, just because these programs increase prices does not mean that they should be scrapped. It does mean, however, that any effort to reduce inflation would be incomplete unless it included a careful weighing of the advantages and disadvantages of government actions that directly raise costs and prices.

Incomes Policies. Public debate on incomes policies typically centers on direct wage-price controls. There is currently little public enthusiasm for direct controls; indeed, no statutory authority for such a program exists. Other less extreme types of incomes policies, however, have received some support.

A mild form of incomes policy is public monitoring of wage-price developments combined with exhortation of labor and management to restrain increases. This is the approach used in the Administration's "deceleration" program. The White House has been attempting to secure voluntary commitments from labor and business to hold wage and price increases below the average of the previous two or three years. The problem is that such voluntary cooperation has been difficult to obtain. As explained in Chapter III, unions are under great pressure from their members to maintain traditional real income growth, which would likely not be possible under the deceleration program.

Another type of incomes policy that does not rely on voluntary cooperation has received a considerable amount of attention recently. Tax-based incomes policies (TIP) either impose a tax penalty on firms and/or workers for exceeding preestablished wage-price norms or they offer a tax incentive for staying below the norm. An advantage of the TIP approach is that it involves less interference in specific wage and price decisions than occurs under direct controls. A disadvantage is that it would impose another major function on the tax system. Relatedly, the administrative burden--public and private--could be substantial, especially under the tax incentive variant.^{7/}

^{7/} For a full discussion, see Arthur M. Okun and George Perry, eds., Brookings Papers on Economic Activity, 2, 1978.

Supply-Enhancing Policies. A fundamental source of inflation is supply shortages resulting from production capacity inadequate to meet demand or from shocks such as adverse weather or foreign trade embargoes. The Congress could deal with the problem of supply shortages in a variety of ways:

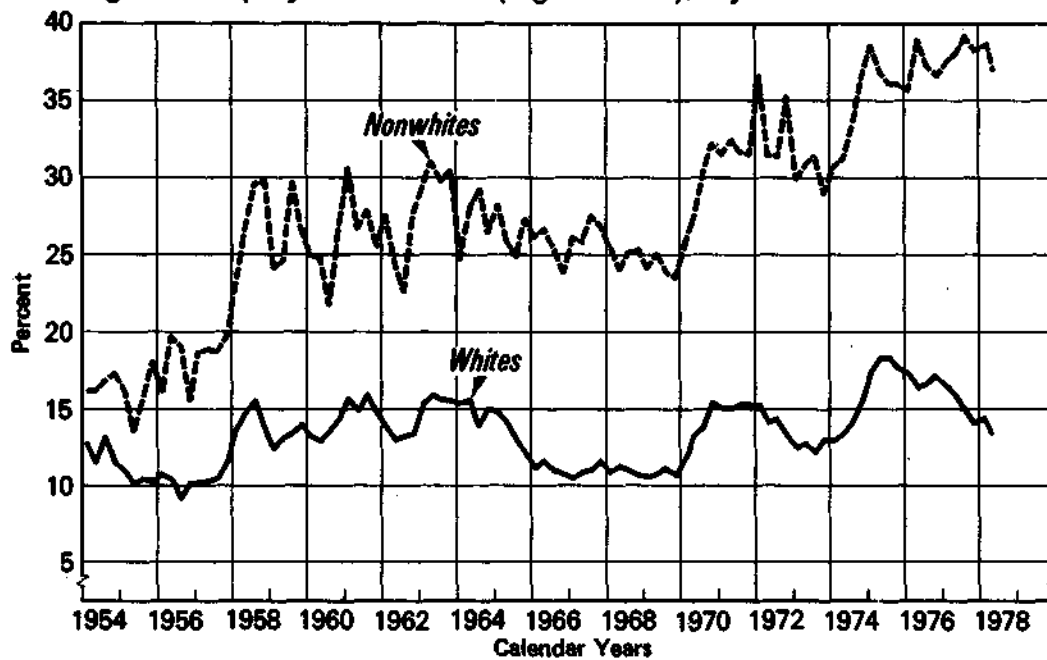
- o As discussed earlier in this chapter, tax changes--especially an increased investment tax credit and accelerated depreciation--would increase the rate of return on business fixed investment and encourage greater expansion of productive capacity. 8/
- o Greater public and private investment in the development of labor skills and the dissemination of labor market information could be encouraged.
- o Establishment of carefully managed government stockpiling programs--selling when prices are high as well as buying when prices are low--could help smooth price changes of commodities, such as grains and petroleum, that are subject to weather and foreign shocks; these programs could help dampen rapid price run-ups that ultimately raise the general levels of wages and prices.

Policies to Reduce Unemployment

Labor market data indicate that, after three years of expansion, there still exists significant unemployment by mid-year--especially among particular groups in the economy. The extremely high jobless rate of black teenagers is unprecedented since the 1930s for any major group in the country (see Figure 8.) The unemployment rate for young black adults (aged 20 to 24) is also exceptionally high at more than 20 percent, and the ratio of the jobless rate for blacks of all ages compared to whites is 2.4:1. The current level of joblessness for poverty sections of metropolitan areas also remains very high (see Table 16).

8/ For a more detailed analysis of the various options, see Congressional Budget Office, The Economic Outlook (February 1978).

Figure 8.
Teenage Unemployment Rates (Age 16-19), By Race



SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

TABLE 16. TOTAL AND NONWHITE UNEMPLOYMENT RATES IN POVERTY AND NONPOVERTY AREAS, 1973 AND FIRST QUARTER OF 1978

	1973		1978:1 ^{a/}	
	Total	Nonwhite	Total	Nonwhite
Poverty Areas	6.5	10.8	9.4	15.8
Metropolitan	9.0	11.6	13.0	17.8
Nonmetropolitan	4.7	9.3	7.2	12.4
Nonpoverty Areas	4.6	7.5	6.3	11.1
Metropolitan	4.7	7.4	6.2	11.0
Nonmetropolitan	4.3	8.2	6.6	11.7
All areas	4.9	8.9	6.2	12.3

SOURCE: U. S. Department of Labor, Bureau of Labor Statistics, Employment and Earnings, January 1975 and April 1978 issues.

NOTE: "Poverty areas" are census tracts where at least 20 percent of persons with incomes below the Census Bureau's poverty standard in the 1970 census. In 1978:1, approximately 16 percent of the civilian labor force lived in "poverty areas" but 45 percent of all nonwhite workers lived in such areas.

a/ Not seasonally adjusted, except for all areas.

In dealing with the unequal burden of unemployment, the Congress has available both macroeconomic tools and structural programs. Fiscal and monetary policies that sustain rising total demand have a significant impact on the relative employment prospects of blacks; an analysis of past relationships indicates that job opportunities of this group are especially responsive at the later stages of an economic expansion (see Table 17).

TABLE 17. EMPLOYMENT GROWTH SINCE THE RECESSION TROUGH, BY DEMOGRAPHIC GROUPS, PERCENT CHANGE

	1975:1 to 1976:3	1976:3 to 1978:1
Total Employment	4.1	6.0
White Teenagers, Age 16-19	4.0	5.5
Nonwhite Teenagers, Age 16-19	0.2	8.3
White Adult Females	6.2	8.1
Nonwhite Adult Females	7.7	11.1
White Adult Males	2.5	4.1
Nonwhite Adult Males	4.2	7.6

SOURCE: Calculated from Bureau of Labor Statistics data.

NOTE: "Adult" refers to persons aged 20 and older.

There is a major limitation on the use of fiscal and monetary policies to solve the problem of the unequal distribution of joblessness. Inflationary production bottlenecks would likely be encountered before unemployment was reduced to an acceptable level. Therefore, it has been recommended that the Congress supplement traditional macroeconomic policies with a greater effort to expand the productive capacity of the economy. Measures that could encourage such an expansion were noted above. Manpower programs could be increased and tightly targeted on disadvantaged groups; such programs could include tax credits to encourage private-sector skill training. In addition, it has been argued that a youth differential in the statutory minimum wage would encourage business to hire and train teenagers.

The problem of the unequal distribution of unemployment could also be alleviated to some extent by expanded public employment programs. These programs provide both an alternative to public income support and work experience that may enhance the worker's chances of obtaining a private sector job.

Even if successful, however, training and public employment programs are best used as complements to, not substitutes for, fiscal and monetary policies that hold down the level of cyclical unemployment. Clearly, the effectiveness of structural programs is improved when labor demand is high.

CONCLUSION

Past experience indicates that monetary and fiscal policies have little capability for dealing with high inflation without incurring substantial costs in terms of output and employment. This limitation of macroeconomic policies suggests that, in the present circumstances, it would be useful to investigate closely other measures, such as policy composition and structural programs, that could eventually improve the tradeoff between inflation and unemployment. Such structural improvements, however, are not a panacea for the current economic ills, and the near-term resolution of the inflation-unemployment dilemma still will depend on whether the Congress, the Administration, and the Federal Reserve give greater emphasis to inflation or to sustaining economic growth.